



Chapter One

Introduction

The Inquiry

Under the Committee's mandate,¹ a role of the Public Accounts Committee is to follow up issues raised by the Auditor-General in his reports to the Legislative Assembly. The Auditor-General has reported to Parliament about the Grains Board every year since its creation in 1991. The Committee is able to examine any circumstances in those reports and bring them to the attention of the Legislative Assembly.

At its meeting of Wednesday 11 October 2000, the Committee resolved to examine issues of interest in relation to the poor financial performance of the Grains Board, notably the efficiency and effectiveness of its operations during 1999 and 2000.

Five public hearings were held during November 2000. The hearings involved past and present directors and employees of the Grains Board, the Department of Agriculture, the Audit Office, growers associations, grain growers, and other industry groups. Further, the Committee undertook desk research and has maintained an active watch over media reports and industry comments relating to the Grains Board.

Creation of the Grains Board

The NSW Grains Board was established by the *Grains Marketing Act 1991*. It abolished four previous boards and amalgamated their functions into the current organisation. The previous boards were the Barley Marketing Board, the Grain Sorghum Marketing Board, the Oats Marketing Board, and the Oilseeds Marketing Board.

Most of these boards were having difficulties when the Grains Board was created. In 1989, the sorghum and oilseeds boards were under the direction of an administrator. In 1990, an administrator was appointed to the Oats Marketing Board. Only the Barley Marketing Board was exercising its powers vested by legislation.

In 1991, The Hon. Ian Armstrong, the then Minister for Agriculture, argued the benefits of the new legislation were that it allowed the new authority to operate in a commercial manner and to be financially self-supporting. The Minister also stated the long-term goal of the restructure was to establish a national coarse grains board.²

¹ Section 57(1) of the *Public Finance and Audit Act 1983*

² Legislative Assembly, Parliamentary Debates, 18 April 1991 at p 2525, and 30 April 1991 at p 2746



The NSW Grains Board commenced operations on 1 August 1991.

Operations of the Grains Board

Objectives

The NSW Grains Board is the single statutory marketing authority responsible for the marketing of coarse grains (for example: barley, grain sorghum and oats) and oilseeds (for example: sunflower, canola, safflower, linseed and soybeans) in NSW. The Grain Marketing Act 1991 refers to these products as “commodities” (see section 3). The Act generally discusses the activities of the Grains Board in relation to commodities.

The Act does not list any specific objectives for the Grains Board. However, the Grains Board adopted the following four purposes:³

- provide growers with marketing options while maintaining a philosophy towards pooling and maximising grower returns;
- to manage its relationship with suppliers, growers and customers;
- to manage, on behalf of its stakeholders, the competition from multi-national grain traders, end users, individual growers and local merchants; and
- to consolidate its financial position by increasing its capital base through joint venture activities, and efficient grain accumulation, marketing, trading and funds and resources management.

Clearly, the Grains Board’s principle objective is to increase returns to NSW growers through a single, more powerful entity marketing their products in Australia and overseas. The main benefits of the Grains Board for growers are:

- countervailing power against the greater market power of a limited number of purchasers of their produce;
- countervailing power against ‘corrupt’ (anti-competitive) world markets which depress or distort commodity prices by abuses of market power by purchasers;
- market power to extract price premiums; and
- access to restricted markets where entry is limited to statutory authorities.

Functions

The legislation sets out the Grains Board’s activities and gives the Grains Board advantages in the marketplace, compared with private traders. The most important

³ NSW Grains Board Corporate Policy Manual, July 1996



advantage is that selected commodities, as listed in the *Government Gazette*, are “vested” in the Grains Board.⁴

This arrangement means once NSW growers have made all their domestic sales for these grains, the surplus becomes the property of the Grains Board. The Grains Board manages the overseas sales of these grains, and growers must accept the Grains Board’s prices for these exported amounts. The Grains Board is, in effect, a “single desk” monopoly seller to overseas clients. In relation to malting barley, all NSW production is owned by the Grains Board.

The Grains Board is also empowered to undertake a wide range of activities, in addition to its core role of being a monopoly representative of NSW growers. Its extra functions include:

- appointing agents and buyers to act on its behalf (sections 40 and 41);
- establishing grades of a commodity and fixing their wholesale prices (section 36);
- creating financial reserves to carry out its functions (section 62);
- improving production methods and establishing laboratories and conducting research into commodities (section 43);
- processing commodities and manufacture of products therefrom (section 37); and
- trading in unregulated grains (section 38 – eg, the Grains Board was active in the domestic market for wheat throughout Australia).

Finances

There is no direct relationship between the Grains Board’s activities and the State’s finances. Under the *Grain Marketing Act 1991*, the Grains Board does not represent the Crown, nor does the State exercise financial or operational control over the Grains Board’s affairs. The Grains Board’s accounts are not consolidated with the NSW Total State Sector. Treasury has advised the Grains Board’s activities are not a risk to the State’s credit rating.⁵

The Grains Board is a body corporate required to operate in a commercial manner on behalf of producers and be financially self-supporting. To buy, store and sell grains and oil seeds, the Grains Board appointed agents and operated as a buyer itself, entered into storage and handling arrangements, and conducted its own marketing. As well as sales income, the Grains Board imposed levies on agents.

The Grains Board has traded either through pools or by offering a cash price to the grower at the time of harvest. In the case of pools, growers deliver their product to

⁴ See section 45 of the *Grain Marketing Act 1991*.

⁵ NSW Treasury, Submission to the Inquiry, page 1



the Grains Board where it is pooled with other grower's grain, and the Grains Board pays the grower 80% - 85% of the projected pool price on delivery. The Grains Board sells the grain on behalf of the pool's members. Further payments are made to the growers as profits are realised, or as determined by the Grains Board.

Contributing to the grain pool will provide the grower with a lower initial payment. However, the pool may result in a higher return than the cash price in the long term.

Administration of the Grain Marketing Act 1991

Composition of the Board and the Consultative Committee

The board consists of a Managing Director and six part-time members appointed by the Governor on nomination from a selection committee. At least four of the part-time members must be growers, and at least two must have qualifications in finance, marketing, economics, accountancy, or law.

Under the Act, the selection committee comprises a chairman nominated by the Minister and four members nominated by the NSW Farmers' Association. The selection committee nominates the part-time members. The six board members nominate the Managing Director (sections 5-8).

Table 1: Members of the NSW Grains Board since its inception

Member	Position held	Period of service
Athol Roberts (OAM)	Chairman, Grower Member	July 1991 to 30 June 1999
Ron Paice	Deputy Chairman, Member with Special Qual's	July 1991 to 30 June 1999
Angus Macneil	Grower Member	July 1991 to 30 June 1995
Malcolm Heath	Grower Member	July 1991 to 30 June 1999
John Fargher	Grower Member	July 1991 to 30 June 1995
John Love	Member, Special Qualifications	July 1991 to 30 June 1999
Martin Nixon	Grower Member	July 1995 to 30 June 1999
Graham Peart	Grower Member Deputy Chairman from July 1999	July 1995 to November 2000



Graham Lawrence	Managing Director	July 1991 to September 2000
Don Hubbard	Chairman	1 July 1999 to November 2000
Lance Blockley	Member, Special Qualifications	1 July 1999 to November 2000
Geoffrey Babidge	Member, Special Qualifications	1 July 1999 to November 2000
Barbara Clark	Grower Member	1 July 1999 to November 2000
Geoffrey West	Grower Member	1 July 1999 to November 2000

Source: NSW Grains Board Annual Reports

The Act also establishes a Grain Marketing Consultative Committee. This body makes recommendations to the board on its operations generally and on the board's power to declare exemptions to the vesting provisions (section 11). The Consultative Committee has five members. The NSW Farmers' Association nominates four and the fifth is a representative of the Director-General of the Department of Agriculture.

Accountability Arrangements

Under the accountability arrangements set out in the Grains Marketing Act 1991, the Grains Board is reliant upon:

- direction and control by the board (whose membership mainly comprises grower representatives);
- assistance to the board from the Consultative Committee (largely representative of the NSW Farmers Association);
- annual reports and annual general meetings;
- five year strategic plans presented to the Minister, with annual revisions;
- on-going monitoring by the Director-General of the Department of Agriculture who also has the power to undertake management audits if warranted;
- annual audits of their financial statements by the Auditor-General; and
- board members and prescribed (executive) staff members acting honestly and with reasonable care and diligence in the exercise of their functions.

National Competition Policy Review

A review of the Grain Marketing Act 1991 was commenced in early 1998. The review was undertaken as part of the NSW Government's commitment under the Competition Principles Agreement. The general aim of these reviews is to remove anti-competitive arrangements, unless there is a net public benefit in maintaining



them. This net public benefit includes economic, social, and environmental factors. The review also considered whether the objectives of the Act could only be achieved by restricting competition.

The Review Group comprised representatives from the following:

- NSW Agriculture (Chair and additional member);
- NSW Treasury;
- the Cabinet Office;
- the NSW Grains Board;
- the NSW Farmers' Association;
- the Grain Exporters' Association (GEA); and
- the Rural Marketing and Supply Association (RMSA).

The Review Group submitted its report to the Minister in July 1999. The members' recommendations were in three groups:

- The Farmers' Association and the Board wished to continue the single desk arrangements for domestic and export markets.
- The GEA and the RMSA wished to discontinue the single desk for all markets, with the possible exception of the export of barley to Japan and similar markets.
- The Government members wished to discontinue the single desk for all markets except for the export of barley.

The GEA and the RMSA supported Government members in generally discontinuing the single desk. The Farmers' Association and the Board supported the Government members in continuing the single desk for export barley. Therefore, the position of the Government members became the majority view.

For example, in relation to the domestic market, the majority were:

...satisfied that there was no substantive evidence of potential market failure that warrants continued intervention in the domestic market for any of the commodities vested in the Board. It was observed that these commodities are part of an array of substitutable cropping activities at the farm level and the domestic market for each of these commodities is well developed and contestable.⁶

The NSW Farmers' Association and the Grains Board considered single desk arrangements should continue in both the domestic and export markets. In the domestic market, for example, they argued there are only one or two end-user customers for some grains, especially malting barley. This opens the possibility of market power, thus requiring a marketing agent such as the Grains Board.

⁶ NSW Government Review Group, *Review of the NSW Grain Marketing Act 1991, Final Report* at p xi



In relation to the exception of the export of barley, the majority argued the status of the Grains Board gives local growers access to the high price Japanese market, which is controlled through import quotas. Other overseas markets did not appear to require a single desk. However, it was deemed impractical to have a single desk for just one market. It is interesting to note the only successful predecessor of the Grains Board dealt in barley.

The GEA and the RMSA did not accept a single desk for just one market could be justified. They also argued the current restrictions in Japan were likely to be relaxed in the near future.

After lengthy consideration of the report, the Government announced on 16 August 2000 the Grains Board would continue to hold vesting powers for the next five years. The Minister's press release also announced a working party (Cabinet Office, Treasury, and Agriculture) to help restructure the Board's trading operations. The Board commissioned an analysis of its operations by PricewaterhouseCoopers. The Grains Board's bankers, the Commonwealth Bank and Rabo Bank, which had provided a combined \$350 million commercial bill facility, were to be party to the restructure.

The Grains Board's Recent History

Since its inception, and until its last financial year, Grains Board financial statements reported it was financially self-supporting and gradually built up substantial non-current assets and reserves (or equity funds). As at 31 August 1992, the Grains Board had \$1.8 million in non-current assets and \$4.1 million in accumulated funds and reserves. On 31 August 1999, the Grains Board had grown to having \$8 million in non-current assets and \$24.6 million in reserves.

The reserves were accumulated with the assistance of levies of \$1.50 per tonne imposed on local merchants' purchases and sales by licensed agents. It appears the Grains Board proposed using the scheme to build reserves of \$60 million to use as growers' equity in some form of grower owned cooperative.

The Grains Board's turnover grew significantly in the 1990s. In 1997/98 it sold approximately 1 million tonnes of grain, and this grew to approximately 2.5 million tonnes in 1999/2000. However, the Grains Board's systems were not prepared for this ambitious growth. In particular:

- purchases in 1999/2000 were significantly over budget;
- it increased its more risky cash trading, but only had a thin capital base;
- poor management systems meant the organisation was not sure about its positions with stock and debtors; and
- borrowings grew unchecked.



Following the National Competition Policy review of the Grains Board, PricewaterhouseCoopers conducted an investigation in August 2000 into the Board's financial position. The report concluded the Grains Board could no longer trade in its own right and it should seek an equity partner to continue trading.

In September 2000, the Managing Director, Graham Lawrence, was stood aside by the Board. Similarly, the General Manager Finance was given other duties and later stood down. Mr Lawrence was the sole employee of the Grains Board, remaining on 'paid leave' while his employment contract was under review. His contract was recently terminated.

New Agency Agreement for Grains Board Functions

Following the disclosure of its insolvent status, the Grains Board requested submissions of interest and proposals to address its urgent need for equity capital. It received five responses. These included:

- Graincorp Ltd of NSW, controlled by the Grain Growers Association Ltd;
- ABB Grain Ltd of Victoria & South Australia, formerly the Australian Barley Board;
- AWB Ltd of Victoria, formerly the Australian Wheat Board; and
- Grainco Australia Ltd of Queensland.

On 26 October 2000, Mr Amery, Minister for Agriculture, announced an agreement had been reached between the NSW Grains Board and Grainco. The agency agreement will operate within the framework of the *Grain Marketing Act 1991* until 2005.

Under the agreement, Grainco will have exclusive export rights for barley, canola and sorghum grown in NSW and domestic vesting rights for malt barley. Grainco will take on the majority of the Grains Board's existing contracts with growers. Vesting rights for oats, sunflower, safflower, linseed and soybean grown in NSW have been removed, allowing these commodities to be traded freely.

Grainco Australia will undertake all of the other operations and services provided by the Grains Board such as servicing international and domestic customers. It will also operate the cash trading (mainly canola) and pools (all other grains).

The Minister provided an assurance the authorised buying fee will not rise above \$1.50, and no new levies will be imposed. Grainco's bid was \$25.2 million. The Grains Board's bankers will absorb the majority of its accumulated losses.

Barley growers will be paid their 1999/2000 pool entitlement via loans from the Crown, which would be up to \$13 million. The loans will be repaid from the continuation of the \$1.50 per tonne levy on authorised buyers of grain. The loan agreement between the Grains Board and the Minister is being structured to



safeguard the loans and authorised buyer fee repayments from any separate debt recovery action against the Board.⁷ The administrator has recently determined the actual payments due at \$3.5 million, which means the levy could be for a shorter period.⁸

Grainco Australia began operations as of 6 November 2000 from Grains Board premises. Grainco has absorbed the majority of Grains Board staff to manage its operations in NSW. However, the Committee understands many have now been terminated.

Since then all members of the board, including the Interim Managing Director Lance Blockley, have resigned. Mr Blockley assisted the administrator with the transition of the Grains Board and resigned early 2001. The administrator, Mr Murray Smith from accountants KPMG, commenced on 13 November 2000 to oversee the Grains Board's functions and the sale of assets.⁹

Section 31 of the *Grain Marketing Act 1991* makes provision for an administrator to be appointed by the Governor to take on all the functions of the Grains Board. The Act also provides for compromise arrangements to be negotiated with creditors and for the winding up of the Grains Board.

In a press release dated 19 February 2001, the administrator stated that as a result of the Grains Board's financial circumstances, (in particular issues that were not contemplated at the time the agreements were signed) it may be unable to meet its obligations. The administrator reported to the Minister and the Grains Board's bankers that losses were substantially higher than previous estimates. Unaudited losses to August 2000 are estimated to be in excess of \$90 million. The administrator also stated that if a compromise with creditors were not possible, the Grains Board would be wound up.

Ownership of the Grains Board

The Grains Board was a stand-alone entity without an owner to look after its interests. The Grains Board was a co-operative by nature but growers were not members.

The relationships and responsibilities established by the *Grain Marketing Act 1991* meant ownership was unclear, notably the membership was not easily identified. Section 5 of the *Grain Marketing Act 1991* specifies the Grains Board does not represent the Crown. Growers do not have equity in the organisation, although a growers' equity scheme was being considered for the future. Nor could the role of the NSW Farmers' Association in advising and selecting the members of the board be considered ownership.

⁷ NSW Treasury submission to the inquiry dated 18 December 2000

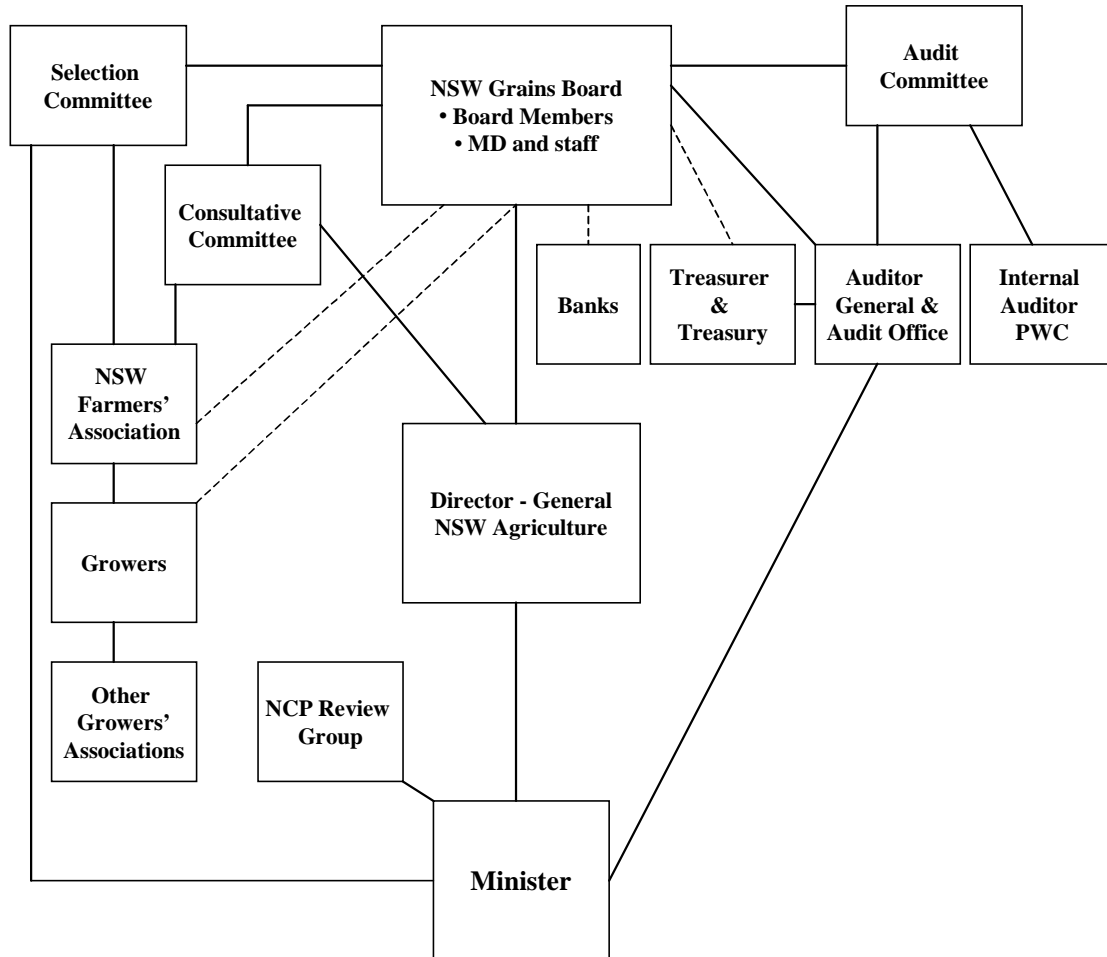
⁸ See "Short Changed \$9.5m" *The Land*, 26 April 2001 at p 1

⁹ Section 31 of the Act permits the Governor to appoint an administrator of the Board.



However, many groups wished to influence its actions. The figure below represents these key relationships.

Figure 1: Grains Board: Key Relationships



Notes - Dotted line indicates a financial transaction (loan, grains sale, or sponsorship of NSWFA)

- Representatives on the NCP review group were sourced from NSW Agriculture, Treasury, the Grains

Board, growers' associations and the NSW Farmers' Association.



There is a great deal of confusion about who owned the Grains Board, or who the shareholders might be. Section 5(2) of the *Grain Marketing Act 1991* states it does not represent the Crown. The Grains Board had many stakeholders, including growers, the NSW Farmers' Association, and despite section 5(2), the Government. The Grains Board had discussed a growers' equity scheme, which would have made growers the owners. But in the absence of such an arrangement, the vacuum of ownership could well have resulted in any positive equity reverting to the Government.

The report explains how one of the main reasons for the Grains Board's collapse was its unusual nature. Ownership and control were poorly linked and defined, leaving the Grains Board in a corporate no-man's land without anyone's interests aligned with those of the organisation.



Chapter Two

Corporate Governance Framework

Introduction

The Board comprised six part-time directors and the Managing Director. A Selection Committee appointed the part-time members, and the part-time members appointed the Managing Director.

Best Practice – NSW Audit Office

Boards must act in the best interests of the board and the organisation, not the interests of the group they represent. Non-executive directors should be independent of management and free from any relationships that materially interfere with their roles.¹

However, the NSW Farmers' Association largely controlled the appointment of the Board through its representation on the Selection Committee, which comprised five people. The Minister nominated its chair. The remaining four people were appointed by the Minister from a list of six people nominated by the Farmers' Association. At least four of the part-time members are required to be growers, and at least two are required to have commercial expertise.²

Best Practice – Australian Barley Board

Where a board has conflicting objectives, they should be explicitly stated and formal mechanisms provided to deal with them.³

Conflicting Objectives: The Cooperative Syndrome

This report gives extensive consideration to whether board members had conducted themselves in the manner required by their responsibilities. In order to make this assessment, one important consideration is the structure of the legislation that provides the framework within which the board members operate. The Committee is concerned that the *Grain Marketing Act 1991* establishes conflicting objectives for the members of the board to pursue. The flawed legislation resulted in what the investigating accountant termed a cooperative syndrome:

CHAIR: My concern is did the board always act in the interest of the growers, were they obliged to...?

¹ See *Corporate Governance, Volume Two: in Practice* NSW Audit Office, Performance Audit Report (1997) at pp 23 & 24.

² Sections 5 – 8 of the *Grain Marketing Act 1991*.

³ See ABB Grain (formerly the Australian Barley Board) *Annual Report 1999* at p 6.



Mr HEDGE:⁴ In the private sector as well the growers were not the shareholders. The growers were the customers.

CHAIR: But they have ended up with a liability, have they not?

Mr HEDGE: No, the customers have in fact been paid over the market value for their product in many cases, which has left the board financially distressed. It is a very common mistake for co-operatives to make where the management is trying to be best friends with the people who are also their customers. Many co-operatives, and I call it the co-operative syndrome, fall into this trap where, in trying to over deliver and ingratiate themselves to their customers, they actually threaten the very foundation of the organisation that they represent. The customer will never say, "No, do not give me more" because the customer knows they are not a shareholder and they are not losing anything if the entity goes broke. So they will take as much as you will give them because they are not a stakeholder.

In a publicly listed company, the shareholders, the board, and the company's clients are usually different groups of people. The shareholders are able to put pressure on the board to make the company perform through management, who puts more effort in improving the financial performance of the company. The shareholders benefit from the company doing well.

The difference for the Grains Board was the relationship between the organisation, the board and the clients was different. The Grains Board was meant to represent the best interests of growers, while the growers were more like clients, not shareholders. Growers were not primarily concerned about the Grains Board's financial performance because their commercial interests in the Grains Board were as clients, not shareholders.

The Grains Board was meant to be a pool trader and minimising any need for equity, and so the *Grain Marketing Act 1991* created a cooperative (of sorts) instead of a trading company. This meant many of the checks and balances usually found in a company were absent in the Grains Board.

Board members were selected by the customers of the Grains Board and therefore the pressure on the board from the grains community was for good commodity prices. Substantially less pressure existed for good financial performance.

In evidence, employee traders discussed how the Grains Board had to maintain its popularity with farmers, instead of taking hard commercial decisions that protected the organisation by using its monopoly position:

CHAIR: But you can just choose not to purchase it.

Mr HAIRE:⁵ Ah! Yes we can, but how can the Grains Board not be buying the New South Wales farmers' canola?

⁴ Investigating accountant, PricewaterhouseCoopers, transcript of hearing, 29 November 2000 at p 50



Mr JEFFRIES:⁶ With a single desk.

Mr HAIRE: With a single desk? "Patrick, what are you doing? You are the canola trader. I have all these farmers on the phone. They want a price for their canola."

CHAIR: But is it not in the interests of the Grains Board to say, "We are not going to trade."

Mr HAIRE: That is the key to the whole issue, Mr Chairman.

The legislative connection between the Grains Board and its clients meant political factors complicated the relationship, impeding the commercial independence of its operations:

Mr WOODS:⁷ The other industry participants are somewhat beholden to you because of the amount of money you are going to spend on storage, freight and various things, and the same with how much grain you are going to sell overseas. On the other side of things, you were more beholden to the growers on the ground that if you kept doing wrong they would not support you politically. It was all much of a political thing. You need the support of the farmers, the New South Wales Farmers Association to stay in business. There was more pressure that way than the other way.

This conflict of objectives between serving the grains communities and ensuring financial performance was illustrated in the Grains Board's Corporate Policy Manual, which lists four purposes for the organisation. The first is to maximise grower returns, and the fourth is to consolidate the Grains Board's financial position by increasing its capital base. The members of the board were attempting to represent both the organisation and growers. Although these conflicting commercial objectives can be reconciled, it would require discipline and a strong will from the board.

Since most of the board members were growers and living within grower communities, it is clear there was a reluctance to push management for lower purchase prices and for price risks to be borne by farmers. They would be criticised by their peers. However, board members had both a statutory and common law duty to act in the financial interests of the Grains Board. It is clear these obligations were overwhelmed by the pressure of the NSW Farmers Association and the farming community.

Even though responsibility for the Grains Board's failure can be clearly placed with the board, there was some sense of inevitability given the deficient structure of the legislation and its conflicting objectives. While the legislation placed board

⁵ Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 36

⁶ Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 36

⁷ Former trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 11



members in this difficult position, it made the task even more difficult by requiring growers to be board members.

Conflicting Interests: NSW Farmers Association

As noted earlier, the NSW Farmers' Association was very influential in appointing the Board. It nominated all the individuals eligible for four of the five places on the Selection Committee. Further, the Farmers' Association nominated all the individuals eligible for four of the five places on the Grain Marketing Consultative Committee.

Best Practice – NSW Audit Office

The composition of boards should be balanced with a cross section of interests and expertise and not allow a specific interest group to have undue influence over decisions.⁸

The involvement by the Farmers' Association was designed to ensure the Board represented growers' interests. However, the composition of the board failed to meet this best practice standard in two ways:

- Growers' interests prevailed at the expense of good commercial practice and this can be partly attributable to the structure of the governing legislation. The members of the board were mainly growers and so were the members of the Consultative Committee.
- The NSW Farmers' Association was the only organisation determining the farmer representatives. This became a problem as the industry evolved and divergent views developed.

Best Practice – Public Accounts Committee

Independent consultative committees that provide advice to boards should have clear roles and responsibilities. They should also have effective links with a cross-section of clients, agencies, and ministers.

The Consultative Committee should have made more use of other stakeholders within and outside government. The composition of the Consultative Committee does not meet best practice. The Committee also notes Ministers accepted the results of the selection process for board members and the Consultative Committee.

The NSW Farmers Association was required to appreciate the responsibilities borne by prospective board members, thereby selecting appropriately qualified and

⁸ See Corporate Governance, Volume Two: in Practice NSW Audit Office, Performance Audit Report, 1997 at p 24.



experienced candidates. Eligibility criteria for nomination was the responsibility of the NSW Farmers Association, and it appears it failed in this regard.

There were doubts raised during the inquiry about the suitability of the Farmers' Association to be the sole representative of grain growers. It represented all agricultural businesses, rather than the sub-set of grain growers. A significant proportion of growers favoured deregulation but the association's dominance was enshrined in legislation. This dominance was resented by other grain grower groups.

The *Grain Marketing Act 1991* gave the Farmers' Association considerable power over its rivals such as the Grain Growers' Association and the Rural Marketing and Supply Association. The Grains Board and grain growers were being used by the Farmers' Association in its political battle with other growers' groups.

These issues were discussed in evidence:

Mr TORBAY: ... New South Wales Farmers Grain Committee Chairman, Keith Perret, said he expected the new arrangement would address the major concerns of growers and ... he welcomed the Minister's assurances in respect of other matters in respect of the \$1.50 levy. They were clearly expressing support for the Government's new arrangements. If that was resolved by the majority of members on the floor, I am just interested in the conflict here: If the community/industry is saying one thing, how can New South Wales Farmers get it so wrong?

Mr BARRON:⁹ I would like to know the same thing. The year before last we went down and had a very good debate - or actually the night before there was a forum, a grains forum, which all the other participants in the annual conference do not come to, it is only the grains people, and the overwhelming majority of people in that forum supported change. There were only the small amounts of people tied to the committee and tied to the Grains Board that supported the retention of those powers.

On the floor of the annual conference, I do not know what happens, but all of a sudden there are egg producers and dairy farmers and oil producers and people who have feed lots and goodness knows what else, and I cannot tell you, but I know that the year before last there was a very close vote on that. I might say that the Grain Growers Association has a large and well-informed advice structure and we had fifty growers at one of our meetings that devoted much of the debate on this issue and it was unanimous support for substantial deregulation of oilseeds and coarse grains industry in New South Wales.

The Committee is also concerned growers who supported deregulation may not have been given adequate hearing within the Farmers' Association:

Mr RINGLAND:¹⁰ ...the people who stood up and were anti the regulation process were almost treated as pariahs. I mean you were not game. In a New South Wales

⁹ Grain Grower, Ungarie, transcript of hearing, 13 November 2000 at pp 49 & 50

¹⁰ Grain Grower, Narromine, transcript of hearing, 13 November 2000 at p 51



Farmers meeting that I went to four or five years ago, a fellow got up and tried to speak against the powers of the Grains Board and he got booed and heckled and whatever, because that is part of the process that people use to maintain the powers they have.

The Committee is satisfied the organisation's financial problems were partially caused by the board and Consultative Committee being largely composed of growers appointed by the Farmers' Association. Although this is a privilege created by legislation, it requires the practise of responsibility in how that privilege is exercised. In addition, this arrangement did not adequately convey the full range of growers' views to the Grains Board.

Best practice demands non-executive directors should be independent of management. However, evidence was given during the hearings how the closeness of the Farmers' Association to the Grains Board was restricting scrutiny of its activities:

Mr BARRON:¹¹ ... as far as an organisation that could act as a commentator, a watchdog and whistle blower on the activities of the Grains Board they were useless and the reason was that they were so close.

Basically they had an incestuous relationship between the Grains Board and the Farmers Association. The grower organisation was – I won't say corrupted by power but corrupted by the nearness to the decision making and that was a terrible disappointment to me.

Three or four years ago I warned them at the annual conference that they were getting too close and could not efficiently act as an organisation to blow the whistle on that activity.

Ms HODGKINSON: You warned the farmers at the New South Wales Farmers conference about the New South Wales Grains Board?

Mr BARRON: Absolutely. This was a great concern. The Grains Board was the chief sponsor of their annual conference.

Ms HODGKINSON: Was that year after year?

Mr BARRON: Year after year. It became, as a former member of that committee and organisation, a great disappointment that they lost that ability, that impartiality.

The evidence indicates the Farmers' Association was determined to continue the role of the NSW Grains Board, regardless of increasing dissent from growers.

The sponsorship arrangement between the Grains Board and the Annual Conference of the NSW Farmers Association was very inappropriate. There was an obvious conflict of interest for the Grains Board to sponsor the same organisation that

¹¹ Grain Grower, Ungarie, transcript of hearing, 13 November 2000 at p 48



selected its Consultative Committee, scrutinised its operations and recommended its board members. There was also a conflict of interest, given the NSW Farmers' Association was involved in the National Competition Policy review of the *Grain Marketing Act 1991*.

Growth in Volumes – the National Competition Policy Review

The Grains Board's turnover increased from 306,000 tonnes in 1991/92 to over 2.5 million tonnes in 1999/2000. This represents a compound increase of approximately 30% per annum. During the last two years in this period, growth was 50% per annum. However, the Committee received conflicting evidence about who was pushing for growth. The Interim Managing Director provided the board's perspective:

Mr BLOCKLEY:¹² ...Subsequently, and I am not sure of the timing but in March or April [2000], the grain receipts showed up in the board papers as being markedly ahead of the budget. The commodity that is highest in my mind is canola, where the budget was in the order of half a million tonnes, whereas actual receipts were 1.2 million tonnes, so that is over twice the budgeted level. One has to ask the question why management did not bring down the gate once the budget had been fulfilled. But, clearly, throughout the whole of this period the National Competition Policy review was high in the minds of management and the securing of the future vesting rights and single desk were a priority, and particularly Graham Lawrence was of the view that the more volume traded, the more the growers depended on the board, the more likely the board would have support, the more likely the board would continue in the future.

In talking to the trading staff subsequent to my installation as interim Managing Director, it would appear that there had been a thrust for volume for volume's sake. Information was never tabled at the board meeting that that was the strategy that was being followed by management.

Graham Peart, a board director since 1995, told the Committee in relation to the 1999/2000 season:

Mr PEART:¹³ ... my summary is that the wheels apparently began to fall off because the management went for growth of the business above everything else.

Compare these views with that of the prior Managing Director, Graham Lawrence:

CHAIR: ... If you have 50 per cent growth in the last two years and the average growth before that was much lower, I would say there is no restraint.

Mr LAWRENCE:¹⁴ I guess it comes down to what your philosophy is in running any business and, as I said, the culture of the Grains Board was a growth culture. That was from the board right through the organisation.

¹² Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 17

¹³ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 3



CHAIR: But that is the wrong culture, is it not? The real culture should be the bottom line. That is your responsibility under the Act.

Mr GLACHAN: So was the board saying to you, "Grow the business. Make it grow"?

Mr LAWRENCE: Absolutely.

Mr GLACHAN: Was there pressure on you from the board to buy more and more?

Mr LAWRENCE: There was pressure on the board from outside the organisation.

Mr GLACHAN: From growers?

Mr LAWRENCE: From growers particularly. There was also, as a result of that, I believe, the board's strategy to meet the requests and perform for farmers.

Mr COLLIER: What about pressure from the board to you?

Mr LAWRENCE: Yes, that was also there.

Traders suggested Mr Lawrence pursued growth, but with the Board's knowledge:

CHAIR: ... who made those [volume] decisions?

Mr HAIRE:¹⁵ I believe that was Mr Lawrence.

CHAIR: Can you explain why he would have made that volume issue decision?

Mr HAIRE: As I said, I initially supported the concept. Certainly, when you raise volumes, you are a more viable player in the market place from the point of view of customers. Overseas, people look upon you as a credible, worthwhile trading partner because you have volume to offer them.

CHAIR: So it helps you to secure a market?

Mr HAIRE: Yes, it does, and the other thing was that I believed that the Grains Board had to grow or die in terms of volume in the market place.

CHAIR: Is that because of that National Competition Policy review that recommended deregulation?

Mr HAIRE: Not just because of that but I think that was certainly a very important point.

Mr JEFFRIES:¹⁶ I think it was an influencing factor.

¹⁴ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 36

¹⁵ Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at pp 37-38

¹⁶ Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at pp 37-38



CHAIR: Management, in effect, were acting in their own interests in the sense of trying to get the trade, volume and relevance up of the organisation so that you have an effective argument against deregulation in the industry?

Mr HAIRE: Yes, but I think the board also understood that strategy...

Industry players outside the Grains Board confirmed growth was management's response to the National Competition Policy review:

Mr HAMMOND:¹⁷ ... While all of this was happening a review was in progress and there was pressure on Mr Lawrence to prove that the board was actually contributing to the New South Wales market and that they were worthy to be retained in that position and I honestly believe that that was driving them.

Mr Woods, a Grains Board trader who left in November 1998, provided corroborating evidence that the drive for growth was relatively new:

CHAIR: So never at any stage were you asked to trade for the purpose of obtaining volume rather than profit?

Mr WOODS:¹⁸ Two years ago I do not think that was the objective of the Grains Board.

This comment helps the Committee to date the new growth strategy as following close after the commencement of the National Competition Policy review.

In addition to the National Competition Policy review, rationalisation occurring in the industry gave an added reason for the Grains Board to seek growth:

CHAIR: But it is fair to say that the board was concerned about the relevance of the vesting rights, whether they were going to remain and in order to preserve those vesting rights they sought to establish dominance and relevance in the industry?

Mr HAIRE:¹⁹ I believe so, but I think there is a larger explanation as well... It was obvious that in Australia there was going to be rationalisation in the Australian grain marketing and grain handling industry. That is continuing. Not only was it an issue of a single desk preservation in New South Wales but it was only a matter of time, in our view, that we would have to merge or joint venture in some way with other marketing or grain handling organisations from interstate.

On the balance of the evidence, the Committee finds Mr Lawrence pursued a growth strategy. It also appears the directors were aware of the strategy, although probably not aware of its full implications. If growers became accustomed to using the Board and getting good service, there was an increased chance it would continue to

¹⁷ Rural Marketing and Supply Association (RMSA), transcript of hearing, 13 November 2000 at p 56

¹⁸ Former trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 6

¹⁹ Former trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 39



operate, despite what the review found. Sufficient growth would have also given the Grains Board sufficient size to survive rationalisation on its own terms.

Management, by increasing volumes through the Grains Board, was acting in its own interests. The structure of the board made it unlikely the directors would have intervened to stop a growth strategy. Growers had an absolute majority on the Board (four out of seven) and had an interest in growers obtaining good money for their grain.

Changes to the Framework

During the 1990s, the board attempted to change the financial structure of the Grains Board. Although their primary reason was to give the Grains Board a solid capital base, it may also have clarified whose interests the Board was meant to represent.

For example, one of the plans was to convert the Grains Board to a private company, with growers holding equity in the company according to their previous business with the Board. This plan was a form of demutualisation. In this case, directors would have a clear responsibility to shareholders to safeguard and increase the value of their wealth.²⁰ A merger was also proposed.²¹ The Australian Barley Board has already undergone such a change and appears to be functioning well.

Mr Lawrence²² gave the history of the Grains Board's plans:

The directors took action to address the question of inadequate reserves in 1995 with a submission to the State Government, seeking permission to restructure to enable access to extra capital via equity and/or other means. This submission became bogged down in legal debate within the State Public Service which dragged on through successive Governments until 1997. Then State and Commonwealth Governments established the National Competition Policy (NCP) and the National Competition Council (NCC). We were then told that there would be no changes until the NSWGB had been through the review process proscribed by NCP. This review process commenced in April 1998 and was not completed until the 16 August 2000, when the Minister announced that the NSWGB could be privatised and take in outside equity, while maintaining its vesting powers for five years.

The NCP Review Group recommended the statutory monopoly be removed (except in the case of exporting barley), and the Grains Board be privatised.²³ The restructure the Grains Board was seeking may have improved its financial position and the chances the board would act in the best interests of the organisation. However, it would have removed the dominance exercised by the NSW Farmers'

²⁰ See the Grains Board's Annual Reports, 1996-97 at p 4 and 1997-98, also at p 4

²¹ See transcript of hearing, 30 November 2000 at p 39

²² Written statement by Graham Lawrence, Former Managing Director, NSW Grains Board, 29 November 2000

²³ See NSW Government Review Group, Review of the NSW Grain Marketing Act 1991, Final Report at pp xviii-xx



Association over the industry, and possibly involved removing board members and introducing job insecurity within the Grains Board.

Conclusions

Best Practice: The composition of boards should be balanced with a cross section of interests and expertise and not allow a specific interest group to have undue influence over decisions.

- The legislation put the NSW Farmers' Association in a position of excessive influence over the board.

Best Practice: Boards must act in the best interests of the organisation, rather than the interests of the group they represent.

- The NSW Farmers Association used the Grains Board to sustain dominance over the industry and rival grower organisations.

Best Practice: Non-executive directors should be independent of management and free from any relationships that materially interfere with their roles.

- Board members found themselves in the difficult position of balancing the demands of their constituency against their statutory and fiduciary duties to the Grains Board. They failed in this test, particularly when the National Competition Policy review threatened the Board's existence and the enacted dominance of the NSW Farmer's Association.

Best Practice: Independent consultative committees that provide advice to boards should have clear roles and responsibilities. They should have effective links with a cross-section of clients, agencies and ministers.

- Corporate sponsorship and other factors compromised the independence of the Consultative Committee and the board. A wide range of stakeholders were prevented by legislation from having representation.

Recommendation 1

The NSW Government should review all legislation that creates organisations with commercial activities whose objectives have potential conflicts and involve significant business risks. This review should be followed up by legislation to ensure each of these boards have:

- a majority of independent board members with commercial backgrounds; and
- an active consultative committee representing a cross section of stakeholder interests, including industry and government.



Chapter Three

Accountability Arrangements and the Exercise of Responsibilities

Introduction

At the hearings, many witnesses sought to limit the role they played in the events leading to the Grains Board's losses. They did so by stating certain duties were the responsibility of others with limited input required of them. Time and again, individuals with clearly defined responsibilities said they relied on others. However, they themselves did not apply sufficient scrutiny to the other people's work they relied on.

The first cause for this breakdown was that key players had flawed assumptions, or were simply mistaken, about the roles and responsibilities of others, which meant they themselves did not exercise reasonable care. Examples include:

- the board members over-relied on executive management, the Auditor-General's reports, internal control systems, and accounting systems;
- the banks over-relied on audit reports and appear mistaken about the Grains Board's relationship with government;
- the board did not adequately check whether its approved control procedures were being implemented;
- the Managing Director over-relied on his accounting staff and sought to evade accountability by claiming decisions were taken with the board's knowledge and approval.
- the board did not effectively supervise the Managing Director; and
- the Chief Financial Officer had a conflict of responsibilities as he undertook a range of functions which are normally segregated.

The second cause of the breakdown was that key players did not properly fulfil their statutory responsibilities, resulting in ineffective monitoring and reporting. The Consultative Committee, the Director-General of Agriculture, the Auditor-General, and Treasury all had statutory or oversight functions which were not properly executed.

This chapter examines each of the key players to determine to what extent they fulfilled their responsibilities.

The Board

The members of the board were the public face of the organisation. Boards traditionally set the strategy of their organisations and take responsibility for these



overall matters. The board was largely unchanged from 1991 to 1999. However, in 1999, the membership of the entire board changed, except for Mr Peart, who had joined in 1995, and the Managing Director, who had joined in 1991. The Committee took evidence from the previous Chairman, Mr Roberts, the current Chairman, Mr Hubbard, the Managing Director, and two other current directors, Mr Peart and Mr Blockley.

Best Practice – Grain Marketing Act 1991

“It is the duty of the Grains Board and prescribed staff members at all times to act honestly and with a reasonable degree of care and diligence in the exercise of their functions.”¹

As Managing Director, Mr Lawrence had special responsibilities for the day to day running of the Grains Board. His role will be considered later in the chapter.

Best Practice – NSW Audit Office

Governance functions of an effective board include:

- setting strategic directions;
- liaising with stakeholders;
- ensuring compliance with statutory requirements;
- risk management; and
- monitoring performance.²

Over-Reliance by the Board on Other Parties and Mechanisms

It was apparent in evidence board members relied heavily, without sufficient question, on executive management, internal control systems and the auditor’s reports, to an extent that it impeded the exercise of their judgment on whether these systems were effective. Evidence was tendered that board meetings were only a formality:

Mr TORBAY: Is it a fair criticism to say that, given the relationship of the Chairman and the chief executive as you indicated, the recommendations were simply rubber stamped by the board?

Mr PEART:³ There was a strong element of that in that the board was largely a two man board or a two and a half man board, it was the Chairman and the Managing

¹ See section 90 of the *Grain Marketing Act 1991*

² See *On Board: A Guide to Better Practice for Public Sector Governing and Advisory Boards*, The Audit Office of NSW, 1998, at p 6

³ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 15



Director, and that is the way the Managing Director always wanted it run, and the Chief Financial Officer, who was really the other third member of the board...

When asked about how frequently the board disagreed with management recommendations, Mr Lawrence was evasive:

Ms HODGKINSON: ...were there occasions when any of your recommendations were not accepted by the board members?

Mr LAWRENCE:⁴ Many occasions.

Ms HODGKINSON: Can you specify a couple, please?

Mr LAWRENCE: No, but I am sure the board would be more than happy to show you the official board papers, a set of papers, and the extent to which the recommendations were not accepted there. What happened was it was practice for me to write on the recommendation, cross through, write the new recommendation. If the board gives you access to those files and the original file, which should be there, you will see how many occasions the board amended, changed or rejected those recommendations. There were many.

However, the prior Chairman, Mr Roberts, also supported the view the board did not appropriately challenge the proposals put forward by management:

Ms HODGKINSON: Can you recall a time when the Board did not accept the recommendation put forward by the CEO at a board meeting?

Mr ROBERTS:⁵ There were a number of occasions, but I cannot detail them, on the first occasion it was put up and it had to be brought back once or twice before the board would agree to it.

ACTING-CHAIR: So finally he got his way?

Mr ROBERTS: I suppose you could put it that way, yes.

The Committee also found specific cases of the board over-relying on other people and systems without effective monitoring. For example, the board placed great reliance on the organisation's internal procedures:

Mr TORBAY: Athol, could you just give us your opinion of how well the Grains Board managed its activities, particularly in respect of the staff and their activities during your term?

Mr ROBERTS:⁶ Well, as far as I was concerned at board level we had procedures and guidelines in place that did not allow things to happen that have already happened, such as aged debtors ... Then, as far as hedging and foreign exchange was

⁴ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 45

⁵ Former Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 77

⁶ Id at p 69



concerned, we had guidelines put in place that would not allow what I have heard has happened to happen ...so I understand that those guidelines were still in place, but obviously they must have been disregarded to allow the situation to occur that has occurred over the last twelve months.

Mr Roberts was clearly comforted by the existence of controls and guidelines. However, he did not indicate any sense of responsibility towards monitoring compliance with those mechanisms. Another board member supports this reliance:

Mr TORBAY: It might be of assistance to the Committee if you could point out what you believe to be the failures of the Grains Board that contributed to the turnaround in the financial performance that you have acknowledged today was pretty sudden.

Mr PEART:⁷ Yes. As the junior member of the board, the board appeared to have good procedures and procedures manuals to cover risk management, both in forward trading and hedging on grain and forward trading and hedging on currency. They were areas where I had no expertise, but we had people on our staff who reported to the board on those and we had an audit and finance committee who met monthly, or sometimes quarterly, to check the finances with the senior financial officer, so my summary is that the wheels apparently began to fall off because the management went for growth of the business above everything else.

Best Practice – Corporations Law

“A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of [the Corporations Law] and their equivalent duties at common law and equity, in respect of the judgment if they:

- make the judgment in good faith for a proper purpose; and
- do not have a material personal interest in the subject matter of the judgment; and
- inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- rationally believe that the judgment is in the best interests of the corporation.”⁸

The Committee has two concerns with the board’s approach and understanding of their duties. Firstly, it appears the board put limited effort into ensuring the procedures were complied with. Although most board members did not have specialist skills in risk management and foreign exchange, they would be required to use their best endeavours in ensuring compliance. Simply accepting staff reports is not the fulfilment of their responsibilities.

⁷ Former Deputy Chairman, NSW Grains Board, transcript of hearing, 13 November 2000 at p 3

⁸ See section 180 of the Corporations Law under section 82 of the *Corporations Act 1989*.



Secondly, evidence from the Audit Office clearly demonstrates internal procedures in relation to foreign exchange were not complied with and the board was directly advised in this regard:

Mr WHITE:⁹ We actually did a special piece on foreign exchange...

CHAIR: Could you tell us what you found in relation to the hedging policies and practices?

Mr WHITE: For the purposes of the 31 August 1998 audit that as a result of the risk associated with it, that outside the normal external audit team we would request our special structured finance people and Treasury ... to look at their policies and procedures and compliance with those areas and also to look at the financial recording of the transactions for the purposes of the 31 August 1998 financial statements... That report was initially discussed with management and then it was actually tabled...

...It certainly covered areas such as lack of segregation of duties, trade limits, the types of risks associated with the nature of the hedging activities they were doing, whether they were getting clear hedges or semi-hedges, in effect, whether they were rolling short positions into longer ones in order to defer particular issues... Subsequent to that year... we did a further piece of work and went back to the audit committee through the management letter and said, "You have not dealt with certain of these issues that we highlighted to you."

CHAIR: As a proportion, how many of the issues did they deal with?

Mr KHEIR:¹⁰ They dealt with a number of them but there were three important ones that were still outstanding as at 31 August 1999. We reported those again. The most important of those was that the board have a policy that risk positions must be reported to the risk committee and the board weekly and that this should detail any open positions which breached limits. However, this was not being done...

CHAIR: And there were very low levels of compliance?

Mr KHEIR: Yes.

CHAIR: And the third one?

Mr KHEIR: The third one was authorisation of deal docketts. We found that deal docketts for foreign exchange documents were not prepared and authorised by section X, Y, Z of the board's approved policies... The implications that we expressed to the board was that deal docketts which are not prepared and signed under the appropriate delegated authority gives rise to operational risk within the Grains Board ... Management responded, "Yes, you also reported this at the end of 1997/98", and the board considered an amendment to the procedures and agreed that they would do it. This was in 1999.

⁹ Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 78

¹⁰ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 78



CHAIR: But they had not done it?

Mr WHITE: Not at the time of issuing that report.

Mr KHEIR: So we reported it in 1998 and then again in 1999 because it had not been addressed, along with the risk limits and the authorisation.

In relation to the Audit Office's special review of trading operations, former board member Graham Peart had a different recollection:

Mr PEART: ...[The Audit Office] congratulated the board on how well the grain trading and the currency trading was run and to my complete surprise, given that they were the Auditor-General, they said for a grain trading company if anything it is run too conservatively.¹¹

However, the committee analysed the Audit Office's treasury report and it directly contradicts Mr Peart, listing significant breaches of financial procedures. It corroborates the Audit Office's evidence.

In summary:

- The board members relied heavily on internal procedures without appropriate oversight.
- There were considerable periods when procedures were not complied with.
- The board was advised of the non-compliance.
- The board failed to implement management changes to ensure compliance.

This pattern of reliance upon others was apparent many times throughout the hearings. For example, the fact the banks approved an extension of credit was seen, at the time, as a good sign:

Mr HUBBARD:¹² ...In fact, in January or February when management went back to the banks to get an extension of credit, no major issues were raised by the banks, so we took some comfort in the capacity of the organisation to repay the facility.

CHAIR: Just on the issue of the banks, do you believe that the banks were practicing proper due diligence in making these loans?

Mr HUBBARD: ... Clearly not.

The board also over-relied on staff and the auditors:

Mr HUBBARD:¹³ ... in the context of all these other people who were looking at this information and satisfying themselves that the job was essentially under control, how can we second-guess all these other people?

¹¹ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 19

¹² Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 40



The Committee appreciates board members are not technical experts, and must consider the advice and direction of management. However, this does not imply they should passively accept the information submitted to them and rubber stamp proposals from management. Rather, the board should satisfy themselves about the accuracy and suitability of the board papers and ensure management performs accordingly.

Reporting to Board Members

The Committee is concerned board members did not assert their right to be properly informed about the organisation's operations. Reporting to board members was voluminous and the papers were sometimes distributed on the day of the meeting. This issue was raised in evidence:

Mr MACINTOSH:¹⁴ We would get board papers circulated, but that was only for circulation. We had no input during a board meeting whether they were good, bad or indifferent.

Ms HODGKINSON: Those papers were only circulated on the day of the actual meeting?

Mr MACINTOSH: Yes, the day, or sometimes the day before, but generally within no more than 48 hours prior to the board meeting.

CHAIR: They are quite substantial documents, are they not?

Mr MACINTOSH: They were fairly voluminous.

CHAIR: Do you think most board members had read the documents before the board meeting?

Mr MACINTOSH: That is asking me to make an assumption whether they actually read them. It was a lot of paper to read.

Mr Peart, former board member, tabled a copy of the papers for the board's meeting of 24 February 2000. It is 3.5 cm thick. It is unrealistic to expect board members would be able to properly absorb their contents at such short notice. The new board attempted to rectify this problem:

Mr BLOCKLEY:¹⁵ In November, I raised the issue of having a new Chief Financial Officer. My belief was that the level of reporting that we were receiving on the financial activities of the board was voluminous but not very informative and that a different style of reporting was required ...

¹³ Id at p 41

¹⁴ Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at p 24

¹⁵ Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 15



Given the board was so poorly informed, it is not surprising board members neither challenged the organisation's practices, nor established to their own satisfaction whether its operations met basic standards.

A Vision of Growth

As discussed in evidence, from 1998 the board was supporting growth. However, it appears growth during the 1999/2000 harvest exceeded the board's expectations, and the board was not properly informed of this growth at the time:

Mr GLACHAN: Mr Hubbard, in the trading that it does, the Grains Board is exposing itself to risks and risks on the international markets as well. Do you consider that the board moved from a conservative trading strategy to a more aggressive approach perhaps some time in 1998?

Mr HUBBARD:¹⁶ We were clearly looking at the growth in turnover in the organisation...

[However, the] budget was significantly less in volume targets than what eventually turned out. People will ask questions, and I can understand the incredulity of the public to say, "How can you sit on a board and see this thing blow out like this". I would ask any of you to look at the reports presented to the board. It was not clear that those volumes were being traded.

Management was looking to grow. However, the vision had not been developed into an adequate strategy with the necessary direction and control to manage the increasing market and financing risks. The evidence indicates there had not been formal consideration of this matter at the board level.

Mr BLOCKLEY:¹⁷ ...it would appear that there had been a thrust for volume for volume's sake. Information was never tabled at the board meeting that that was the strategy that was being followed by management.

Many witnesses credited this growth vision with the collapse of the Grains Board. For example:

Mr LAWRENCE:¹⁸ In hindsight, I believe we did not have sufficient resources in manpower or information systems to cope with the greater than expected growth that occurred in 1999/2000.

The Committee is satisfied, in a time of expansion, the directors and executive management failed in their key roles of strengthening the organisation's control systems to handle the growth. The following chapters on risk and the standard of the Grains Board's physical systems go into more detail on this issue.

¹⁶ Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 32

¹⁷ Interim Managing Director, NSW Grains Board transcript of hearing, 1 November 2000 at p 17

¹⁸ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 31



Conclusions

On the evidence it appears, as an entity, the members of the board failed to exercise reasonable care and diligence in exercising their functions.

The Committee understands many of the directors were not technical experts in all areas of the Grains Board's operations. However, this does not excuse directors taking passive roles and accepting the status quo. Directors would have been expected to actively determine, to their own satisfaction, whether the Grains Board's operations were up to standard. The new board of directors, appointed in 1999, had commenced taking those steps. Unfortunately, they were too late.

Consultative Committee

The Consultative Committee was the avenue by which grain growers could put their views to the Grains Board about how their grain was being handled. As discussed in chapter two, it comprised one Government appointee and four people appointed by the Minister from a list of six provided by the NSW Farmers' Association. Mr Hubbard (the most recent Chairman of the board) was the chairman of the committee until December 1999. Mr Dalton of the Farmers' Association acted as the secretary of the committee.

Best Practice – Grain Marketing Act 1991

The Act gives the Grains Board's Consultative Committee the following functions:

- to make recommendations to the board in relation to any refusal by the Grains Board to grant, or to revoke, an exemption from its vesting powers;
- to conduct a review every four years of the Grains Board's actions and to make recommendations to the board for its activities over the next four years; and
- to make recommendations to the board with respect to the operations generally of the Grains Board.¹⁹

Evidence from the Consultative Committee's secretary indicated the Consultative Committee exercised no role in supervising the Grains Board's operations:

Mr GLACHAN: So you made all those suggestions but you did not say anything to them about their buying policies? You did not say, "Are you buying too much? Are you paying too much money?" You talked about a whole range of things that you suggested.

Mr DALTON:²⁰ With respect, though, the Act is quite specific in the functions of the Consultative Committee. We were not there to manage the board, and we have

¹⁹ Section 11(2) of the *Grain Marketing Act 1991*

²⁰ Director of Grains, NSW Farmers Association, transcript of hearing, 16 November 2000 at p 4



never been there to manage the board. Those decisions are board decisions, how much do we buy and what do we pay for it. They are not New South Wales Farmers decisions and they are not Consultative Committee decisions.

However, Mr Peart contradicts Mr Dalton and properly acknowledges the Consultative Committee was required to examine operational matters:

Mr PEART:²¹ ...[The] Consultative Committee had the right to ask any questions on any performance levels of either finance, trading, the way the growers were handled.

Mr Peart's evidence is corroborated by Mr Don Hubbard, the Consultative Committee Chairman from the Grains Board's inception until July 1999. He stated in the Grains Board's 1998/1999 annual report:

The annual report for the year ending 31 August 1999 shows good financial management and a strong grain marketing program, in the face of substantial market intervention and subsidies by the European Union and the Asian downturn. The Board is to be complimented on its continued annual average growth rate of 32%, indicating continued strong grower usage of the NSWGB services.²²

Although the Consultative Committee does not manage or oversight the board of directors, it nevertheless has the role of representing growers' interests. From the evidence, it appears the Consultative Committee did not pursue this role adequately. For example, the Grains Board was known as paying high prices for grain. This aggressive approach increased its chances of making losses, endangering its future.

There was some technical discussion during the hearings about the precise meaning of "market price." However, the main point is the Grains Board was prepared to pay a higher price than other industry players. The Consultative Committee does not appear to have considered the possible consequences of these high prices:

Mr GLACHAN: But you knew, because you were making comparisons, as you just told us, of the price the board was paying compared with other people, so you would have known they were paying more than others were paying for grain.

Mr DALTON:²³ Well, we would hope that the board would be paying at least as much as others.

The Grains Board, as a separate entity, was required to cover its expenses. High prices for growers put the future of the Grains Board at risk. This does not appear to have been of concern to the Consultative Committee.

²¹ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 19

²² NSW Grains Board, Annual Report 1998/1999 at p 35

²³ Director of Grains, NSW Farmers Association, transcript of hearing, 16 November 2000 at p 5



There were other cases where the Consultative Committee did not adequately represent growers' interests. For example, traders raised their concerns with the Consultative Committee:

Mr WOODS:²⁴ I resigned in November 1998 ... a few months earlier, Mr Patrick Haire and I informed Mr Don Hubbard, the then chairman of the New South Wales Grains Board Consultative Committee and the last chairman of the New South Wales Grains Board that we had grave doubts about the accountancy figures, the foreign exchange losses, the value of the stock, the management and the ability of the Grains Board to survive under its present structure.

However, there was no evidence these concerns were raised by the Consultative Committee with the board. At the beginning of 2000, there were rumours of financial problems at the Grains Board. However, the Consultative Committee did not see the need for an active approach, preferring to rely on the auditors:

Mr DALTON:²⁵ We were not aware of the financial problems the Grains Board was undergoing until, in fact, they became a question of public knowledge. We had no prior information on that. There are rumours. There are rumours all the time and there have been a lot of rumours over the years about the Grains Board and other authorities and things that we had credence in. The only way you can substantiate those rumours one way or the other is to wait. I indicated earlier that we had confidence in the process of the board's auditors and the process of the Auditor-General's confirmation of the audit, so that, to us, the key to this situation is why did the board's auditors in particular not pick up the other problems with the board? That is, in our view, the guts of the problem.

However, the Auditor-General does not report on operational matters in the independent audit report. It is not the function of audited financial statements to disclose operational risks. Once again, the Consultative Committee merely relied on others to perform their own duties.

The *Grain Marketing Act 1991* states the Consultative Committee's role is to investigate and form recommendations to the board about the Grains Board's operations generally. The Consultative Committee should have been aware of the impact of high prices on the financial stability of the Grains Board. It should have made recommendations to the board of directors in this regard and other operational issues. Waiting to see whether rumours are correct or not is inadequate. The Consultative Committee failed in its statutory duty.

²⁴ Former trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 1

²⁵ Id at p 13



Audit Committee

Best Practice – Professional Accounting Associations

“The board/audit committee should create an atmosphere of openness and accessibility for audit feedback and discussion.”²⁶

The Audit Committee comprised three members of the board and reported to the board. It managed both the internal audits by PricewaterhouseCoopers and the external audits by the NSW Audit Office.

Audit Committees – Best Practice Guide

“The function of an audit committee is to assist the board in overseeing responsibilities in relation to the appropriateness of the entity’s financial reporting, internal control structure and processes, the quality of risk management systems, and the internal and external audit functions.”²⁷

“The audit committee has a responsibility to consider carefully issues raised by the external and internal auditors as those issues may have implications for the entity’s control environment.”²⁸

The approach by the Audit Committee to its work was outlined in evidence:

Mr PEART:²⁹ ... My comfort as a board member was that we were doubly audited; we were audited by Pricewaterhouse who raised in the five years I was on the board no major problems.

Mr GLACHAN: None, to your knowledge?

Mr PEART: None to me – no that is not quite true.

Mr GLACHAN: They did raise something, did they?

Mr PEART: There were always a series of questions raised by both the Auditor-General and Pricewaterhouse, these were always dealt with by the Chief Financial Officer and they were vigorously swept aside in nearly every case, but that was accepted by the auditors.

It appears the Audit Committee did not carefully consider the issues raised by the auditors, given management was able to sweep them aside. Nor did there appear to be an atmosphere of openness and accessibility for audit feedback and discussion:

²⁶ Australian Society of CPAs and Institute of Chartered Accountants, *Beyond the Gap: Report of the Financial Reporting and Audit Expectation Gap Task Force*, (1996) at p 10

²⁷ Australian Accounting Research Foundation, *Audit Committees: Best Practice Guide*, (1997) at p 2

²⁸ *Id.*, at p 21

²⁹ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 8



Mr WHITE:³⁰ ... we found instances at times when we were asking Mr Fitzgerald to table the management letters as you would expect at audit committees. Mr Fitzgerald seemed always reluctant to give our management letters a good hearing. So we would find practices where the management letters would only be virtually turning up at the day of the meeting and we were saying to the audit committee, "How would you be able to give these appropriate consideration?" Certainly you could after the meeting but not prior.

The Audit Committee should have played an active role in dealing with the auditors' suggestions, rather than allow the Chief Financial Officer (whose work was, in substance, the subject of the audit) to dispose of them. Some inquiries by the Audit Committee to the auditors of their views of management's response would also be appropriate. However, it appears these follow-ups were not done.

In this instance, the Audit Committee should not have taken comfort from the audit reports of the financial statements that the organisation was doing well. Rather, it was the Audit Committee's function to form its own view whether the management letters were accurate and to implement appropriate recommendations. In fact, the presumption would be that all of the auditors' recommendations should be implemented. The Grains Board would need strong reasons not to implement any recommendations.

The Audit Committee also failed to deal with on-going audit findings. As noted earlier, the Audit Office made many recommendations in its Treasury review of the Grains Board. However, three important recommendations were not addressed:

Mr KHEIR:³¹ So we reported it [deal dockets] in 1998 and then again in 1999 because it had not been addressed, along with the risk limits and the authorisation.

CHAIR: These are key recommendations out of your report, are they not? What about the recommendations that were implemented? Were they substantial or minor?

.....

Mr KHEIR: A total of about 10 recommendations were made, of which about six of seven were implemented. They were not as major as these ones.

Ensuring these recommendations were implemented would have been the responsibility of the Audit Committee. If they were not implemented, they should at least have been addressed. However, it appears neither action was taken, requiring the Audit Office to raise these issues a second time.

The Audit Committee also had difficulty handling recommendations from the internal auditors:

³⁰ Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 71

³¹ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 79



Mr TORBAY: Generally speaking, were the recommendations that you made to the audit committee always carried out?

Mr WETMORE:³² In the year 2000 we followed up on the recommendations made in respect of 1999 and I think in preparing here, nine out of 20 had been either carried out or some process had been done to address them, maybe not a complete process, so really it left 11 pending as such.

Mr TORBAY: So more than half were untouched?

Mr WETMORE: Were untouched.

CHAIR: You must have been concerned about that?

Mr WETMORE: Once again, the internal audit responsibility is to report it to the audit committee who then, in conjunction with management, must implement these things. We do not manage the organisation.

Under best practice, it is the responsibility of the Audit Committee to support internal audits by addressing the extent to which management reacts to the recommendations. However, the Audit Committee was not active in pursuing them. Management's ability to "sweep aside" audit recommendations has already been covered in this chapter. If an organisation pays internal auditors to get professional advice to improve its systems, one would expect the organisation to implement the recommendations.

The Committee is satisfied the Audit Committee did not carry out best practice in managing the internal audit. It did not appear to take an active role in the audits, allowing the internal auditors to drive the procedure and allowing management to avoid implementing recommendations.

The extent of internal audit coverage is discussed later in this chapter: *Internal Audit*. Risk management, especially of trading risk, is discussed in more detail in chapters four and five.

Managing Director

Prior to working at the Grains Board as Managing Director, Mr Lawrence worked at the Australian Wheat Board. He had worked for the Grains Board since its inception. A Managing Director is traditionally responsible for the day to day running of an organisation, which complements a board's role in providing strategic directions.

³² Internal Audit Partner, PricewaterhouseCoopers, transcript of hearing, 30 November 2000 at p 6

**Best Practice – Professional Accounting Associations**

“The purpose of a board is to ensure that management performs.”³³

“The board should carefully monitor that there is no conflict between corporate and personal goals of the executive team.”³⁴

“The Managing Director should ensure that the management team is strong and competent, that its members are capable of the tasks assigned to them and that there is sufficient depth of support for management.”³⁵

In hearings and in his sworn statement, Mr Lawrence admitted to varying levels of responsibility. At one stage he admitted being Managing Director involved a great deal of responsibility:

Mr TORBAY: Mr Lawrence, you indicated earlier you are not an accountant, but do you accept that as Managing Director you were responsible for the financial management of the organisation?

Mr LAWRENCE:³⁶ I accept enormous responsibility.

However, at times Mr Lawrence became equivocal:

Mr TORBAY: So, essentially, as Managing Director responsible for the day-to-day management of the organisation, you could not control it?

Mr LAWRENCE:³⁷ Let us say that what happened, a lot of which I believe was not totally controllable by the board, by myself, led us to a position different to what we had forecast. I do not know that that says the board or management did not do its job. It just says it could have done its job a whole lot better.

He also denied responsibility by implicating the board:

The board [of directors] has had access to the same information and in virtually the same time frame as myself. This has given the non-executive directors a comparable opportunity to myself to question reports, call for policy changes or investigations, and instruct me to take necessary actions at any time.³⁸

And denied responsibility by implicating others:

³³ Australian Society of CPAs and Institute of Chartered Accountants, *Beyond the Gap: Report of the Financial Reporting and Audit Expectation Gap Task Force* (1996) at p 9

³⁴ *Id* at p 10

³⁵ *Id* at p 11

³⁶ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 46

³⁷ *Id* at p 41

³⁸ Statement by Graham Lawrence, 29 November 2000 at p 6



Mr LAWRENCE:³⁹ ...with regard to the financial numbers, which I relied on because of a number of steps that were in place, the board had external auditors, the board had internal auditors, the board had an audit committee and, of course, there was the board and, on top of that, there were finically qualified people in the employment of the board. If, and only if, the rumours are correct that there are problems with the accounts going back into previous years, then certainly those people who are expert in that field would have to supply some answers as to why that was not picked up before. I certainly relied on the information having been signed off by what I thought was a very exhaustive process of checking and balancing.

Further, Mr Lawrence gave conflicting evidence about the accounting systems. At one stage he sought to deflect responsibility by relying on the audit reports:

Mr COLLIER: ...were you happy personally with the accounting systems in place?

Mr LAWRENCE:⁴⁰ The short answer is yes because there were so many checks and balances put in place. There was an audit committee, an external auditor, internal auditors, qualified accountants on the staff and qualified accountants at times on the board itself. No-one had ever raised with me an inadequacy of the systems or the procedures and every year the Auditor-General had signed off a clean set of accounts and that led me to believe that I could rely on the systems.

Mr Lawrence is not being accurate, the inadequacy of the systems and procedures was raised with him, because he was present at Audit Committee meetings where management was able to sweep aside the auditors' concerns. He also received copies of the management letters. In addition, an unqualified audit report does not imply an organisation's systems are functioning well. It only means the financial statements are free from material mis-statement. This issue is discussed later in the section on the external auditor.

While placing reliance on the accounting system, Mr Lawrence was also critical of it:

Mr GLACHAN: Did you have any concerns yourself about the standard of the financial reporting before Mr Blockley raised the issue?

Mr LAWRENCE:⁴¹ I must say that I had for some time said, "I cannot dissect the information which we have."

Mr Lawrence cannot have it both ways. He cannot simultaneously claim he was happy with the accounting systems and relied on technical experts, yet also had long running concerns with the financial information and was trying to do something about it.

³⁹ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 53

⁴⁰ Id at p 42

⁴¹ Ibid



Mr Lawrence was responsible for ensuring his financial team were competent. However, the following chapters will demonstrate the accounting and computer systems that supported them were very inadequate in times of expansion. These systems were the responsibility of the Chief Financial Officer, Mr John Fitzgerald. The Grains Board's systems will be discussed further in chapter five.

In addition, Mr Lawrence was responsible for ensuring personal relationships among senior staff did not conflict with the Grains Board's corporate goals. However, Mr Lawrence and Mr Fitzgerald had a long lasting and very close relationship:

Mr PEART:⁴² ... Close working relationships - the only ones that I knew of were that Graham Lawrence had worked for the Wheat Board for many years and had been the New South Wales manager of the Wheat Board and it was considered a considerable coup for the Grains Board that they pinched him off the Wheat Board to become the chief executive officer of the Grains Board and John Fitzgerald had been a senior finance officer in the Wheat Board in Melbourne, so Graham Lawrence employed someone out of the Wheat Board whom he knew and they certainly worked very closely together in running the board for those eight years...

Evidence was presented Mr Lawrence strongly supported Mr Fitzgerald when the board began to doubt the Chief Financial Officer's competence. In addition, his severance arrangements were generous and Mr Lawrence did not quickly find a replacement:

Mr BLOCKLEY:⁴³ In November, I raised the issue of having a new Chief Financial Officer...

However, Mr Fitzgerald was defended strongly by Graham Lawrence, and the other board members being relatively new to the board did not feel that they were sufficiently concerned to move against the Managing Director of eight and a half years. However, ... at the January meeting I again requested that we met in private and I said that I was certain that we needed a new Chief Financial Officer, and by that time I had the majority support of the other part-time members and against Graham Lawrence's better wishes, we moved that a new Chief Financial Officer be found and employed for the board and we agreed that a suitable head hunting firm be engaged to find an appropriate person. Unfortunately, that took Graham more time than we would have liked and that person did not take up the helm as CFO until June 2000.

ACTING-CHAIR: Was anyone in the job?

Mr BLOCKLEY: Yes, Mr Fitzgerald remained in the job in that time.

Mr GLACHAN: What happened to Mr Fitzgerald when the new man came in? He left?

⁴² Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 12

⁴³ Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 15



Mr BLOCKLEY: No, he was going to be retired, I suppose, in 2001 under an arrangement that Mr Lawrence had negotiated and he was moved to the head of information technology, IT, because during his eight years as Chief Financial Officer, he had developed the computer systems of the [Grains] Board which appear to be somewhat unique and, therefore, his knowledge was felt to be required to run those systems which you would have to say are different from those of other trading organisations with which I have had experience.

In support of Mr Fitzgerald's employment, Mr Lawrence had arranged for an interest free loan for Mr Fitzgerald. However, the loan had not been approved by the board:

Mr PEART:⁴⁴ ...the auditor came up and said there was, I suspect unapproved, a loan of I think the figure was \$200,000 that had been given to the Chief Financial Officer to induce him to move from Melbourne to Sydney for a housing loan and this loan had no interest on it and was not being serviced. . . .

... I cannot remember whether it was Pricewaterhouse or the Auditor-General who brought it up because we were audited twice each year. There was a hurried meeting and the Managing Director put a proposal to us saying that the Chief Financial Officer was over-worked in his dual jobs of writing all the software for the company and being the accountant, his salary was increased by \$50,000.

Mr GLACHAN: From what to?

Mr PEART: I cannot remember from what to, but those matters are all in the records. It was put on minimal interest of 5% to be paid off over four years.

It appears Mr Fitzgerald received preferential treatment from Mr Lawrence because of their close, long-term relationship. The Committee is of the view Mr Lawrence's close relationship with Mr Fitzgerald prevented him from objectively executing his responsibilities as a Managing Director. This meant the Grains Board had sub-standard computer systems and accounts, contributing to its collapse.

The Committee has concluded Mr Lawrence not only failed as a Managing Director, but also denied responsibility for these failings through evasive answers to questions from the Committee:

Mr GLACHAN: Mr Blockley, soon after he came on to the board, has told us that he began to raise questions about the quality of the financial reporting. What was your reaction to his concerns?

Mr LAWRENCE:⁴⁵ I have always welcomed any suggestion with regard to the reports from board members.

Further,

⁴⁴ Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 9

⁴⁵ Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 42



Mr COLLIER: As Managing Director responsible for the day-to-day management, were you happy with the adequacy of the accounting systems and procedures that were in place?

Mr LAWRENCE:⁴⁶ I think I have said somewhere in my statement I am not an accountant.

Another example:

CHAIR: So the price was above the other States for a long period of time, was it not, in New South Wales?

Mr LAWRENCE:⁴⁷ Well, I am not sure where you are getting that information from.

And:

Mr GLACHAN: What did you say to Mr Blockley when he first raised the issue of his concern about the standard of the financial reporting? What did you say to him?

Mr LAWRENCE:⁴⁸ Look, I cannot remember when he raised it or how he raised it. I can only say to you that my general response to those sorts of issues always was, "I welcome your help. If there is anything that you can guide us by your experience from outside as directors to do, we will do it."

In summary, Mr Lawrence sought to avoid responsibility in the following ways:

- by claiming the board of directors were responsible;
- by claiming he relied on experts beneath him;
- by relying on the auditors; and
- by providing evasive answers.

Mr Lawrence also allowed his close relationship with the Chief Financial Officer, Mr Fitzgerald, to cloud his judgment in dealing with accounting and computing issues.

The Committee was not persuaded by Mr Lawrence's evidence. The Committee is of the view Mr Lawrence sought to avoid responsibilities that were properly his.

Director-General of the Department of Agriculture

The Director-General, Dr Sheridan, manages an agency with a budget of \$232 million in 2000/01. The Department's key role is to assist the NSW food and fibre

⁴⁶ Ibid

⁴⁷ Id at p 34

⁴⁸ Id at p 42



industries to be economically viable and environmentally sustainable. Part Six of the *Grains Marketing Act 1991* (Public Accountability) requires the Director-General to collect information and provide independent advice to the Minister on the activities of the Grains Board.

Best Practice – Grain Marketing Act 1991

The duties and powers of the Director-General under the *Grains Marketing Act 1991* are:

- “to keep under review the activities of the Board and to make regular reports on its activities” (section 68);
- “The board must, when requested to do so by the Director-General, furnish to the Director-General a report containing such kind of information relating to the activities of the Grains Board as the Director-General requests (section 69);
- “... in each year, the Director-General must prepare and forward to the Minister a report of the activities of the Grains Board for the 12 months ending on 30 June that year (section 70); and
- “The Director-General may require management audits to be conducted for the purpose of examining the activities ... of the Grains Board and assessing the extent to which any such activities are being carried out in an efficient, economical and proper manner” (section 73).

The *Grain Marketing Act 1991* through section 5(2), separates the Grains Board from the Government: “The [Grains] Board does not, for any purpose, represent the Crown.” Further, the Grains Board was given a number of functions and powers to enable it to be self sufficient.

However, the Government, through the Director-General of the Department of Agriculture, clearly had an oversight and accountability role in relation to the Grains Board.

In evidence, Dr Sheridan stated he had no prior knowledge of the Grains Board’s problems:

Dr SHERIDAN:⁴⁹ ... my Director of Marketing is on the Consultative Committee that you have just been discussing with the Farmers Association and that has been an ongoing role for the Director of Marketing. I must say that, during the period that those people have been involved until 27 July, we have had no indication of anything askew.

CHAIR: So 27 July is the first time—

Dr SHERIDAN: When it appeared in the *Financial Review*.

⁴⁹ Director-General, NSW Department of Agriculture, transcript of hearing, 16 November 2000 at p 16



In the hearings, Dr Sheridan did not appear to use the *Grain Marketing Act 1991* to commission any of his own inquiries into the Grains Board:

CHAIR: Apart from the National Competition Policy review, what other reviews have occurred in recent years?

Dr SHERIDAN:⁵⁰ There has been the four-yearly review that the Consultative Committee is required to undertake and, as we are part of the Consultative Committee, we are part of that review. But it is really an ongoing review process, as I pointed out, because of the ongoing interaction between the Minister, the Grains Board and the department, and information is provided at all times.

Dr Sheridan stated he had a number of other information sources about the Grains Board, upon which he relied:

Dr SHERIDAN:⁵¹ ... the Auditor-General does the final analysis of all the reports. I have a member on the Consultative Committee. We have correspondence and ministerial memorandums. We have a National Competition Policy review. We have discussions about the equity participation scheme. That has been going on for nine years. That is the information that flows to me. It is not just an annual audit report from the Auditor-General, and on the basis of all information that flows to me, I was satisfied with what was going on.

Further, all these reports stated the Grains Board was performing well:

Dr SHERIDAN:⁵² ... prior to [27 July 2000] – all of the reports we have received, including the Auditor-General's report in regard to the operations of the Grains Marketing Act, have all been very, very satisfactory and quite glowing.

However, the *Grain Marketing Act 1991* does more than request the Director-General to rely on others' reports on the Grains Board. One would expect the Director-General to be briefed on these reports anyway. Rather, the Act recognises the Government, and especially the Minister, have significant responsibilities to the community for the Grains Board's operations. Therefore, Part Six established a mechanism for the Director-General to actively monitor those activities outside normal reporting routines.

It appears that from the Board's establishment in 1991, up until the PricewaterhouseCoopers investigating report in 2000, no investigations were conducted by the Department of Agriculture into the Grains Board. Given the importance of the industry and the legislative duty in Part Six, the approach taken was inadequate.

The statutory audit reports would generally be brought to the Director-General's attention. There were several items in each report worthy of investigation. For

⁵⁰ Id at p 17

⁵¹ Id, at p 25

⁵² Id, at p 18



example, the report for 1998/99 stated \$2.7 million was approved by the members of the board to be transferred from the growers' residual interest in pools to the Board's operating income. The amount appeared to be the residual funds remaining after the finalisation of various pools up to 1997/98. The transfer of \$2.7 million was the difference between the Board recording a profit or loss, because in 1998/99 the Board earned an operating profit of \$2.45 million.

Such questionable conduct and marginal results warranted investigation. The Committee accepts action at this stage would not have prevented the Grains Board's losses in 1999/2000. However, it would be reasonable to expect the Director-General would have been better informed about the Grains Board's finances by 27 July 2000.

The evidence before the Committee indicated the Director-General failed to fulfil his duties under Part 6 - Public Accountability of the *Grain Marketing Act 1991*.

NSW Treasury

Treasury has two components: the Office of Financial Management (OFM) and the Office of State Revenue. The OFM is relevant to this report. It "serves the Treasurer and the Government by providing economic advice and advising on, and accounting for, the overall management of the State's finances."⁵³

Best Practice – Treasury Corporate Objectives

Two of Treasury's corporate objectives are:

- "to improve the allocation of resources and to achieve positive social and environmental outcomes for the State, including enhanced public sector net worth;" and
- "to improve public sector accountability for State financial management."⁵⁴

NSW Treasury provided a submission to the Committee. The agency argued the Grains Board does not have any impact on NSW's finances. Excerpts include:

Treasury only became aware of the financial difficulties of the Board when they became public around July 2000...

Treasury does not actively monitor the Board as the Government has no ownership interest in the assets of the NSW Grains Board and does not guarantee the Board's operations...

The State does not exercise financial or operational control over the Board's affairs. The Board's accounts are not consolidated with those of the State and therefore no

⁵³ Budget 2000/01, Budget Paper No 3, at pp 21-2

⁵⁴ NSW Treasury website, www.treasury.nsw.gov.au/mission.html, downloaded on 12 March 2001



analysis of contingent liabilities is sought or undertaken. The Board's activities are not a risk to the State's credit rating. The State is very unlikely to approve a change of policy whereby the financial losses of regulatory marketing bodies such as the Grains Board are underwritten by the State.⁵⁵

The submission also stated the Treasurer has asked for quarterly reports from the Minister for Agriculture from February 2001 through to September 2005. This date is when the "sole agent" contract with Grainco ends. The reports are to monitor the loan of up to \$13 million provided by the Crown to the Grains Board to fully pay barley pool entitlements for 1999/2000.

The Committee accepts the Grains Board does not represent the Crown. However, there are a number of factors to suggest the Grains Board has an indirect relationship with the State's finances and Treasury, as the Government's financial experts, should have applied some scrutiny to the Grains Board's operations:

- The Grains Board is linked to the State, especially through accountability processes – see Part Six of the Act. One of Treasury's corporate objectives is to improve public sector accountability for the State's finances.
- The Treasurer also received copies of the Auditor-General's statutory audit reports.
- NSW's economic performance depends, in part, on the grains industry. The Grains Board had an obvious impact on this sector. One of Treasury's corporate objectives is to improve the allocation of resources in NSW.
- Treasury shadows the performance of other economic agencies and public sector bodies. For example, it applies intense scrutiny to the electricity industry and advises the Treasurer on applications for assistance by the Department of State and Regional Development.

Recommendation 2

Treasury should examine the possible exposures to the State's finances from the operations of statutory authorities not under regular review. Treasury should also provide ongoing monitoring of the higher-risk statutory authorities.

It is the Committee's view Treasury's supervisory function does extend to covering statutory marketing authorities and the submission provided by Treasury evades this responsibility. Treasury stated the financial losses were not to be underwritten by the State. However, Treasury contradicted itself by lending \$13 million to the Grains Board.

⁵⁵ Treasury submission, 18 December 2000 at p 1



Banks

The role of the banks was outlined during evidence:

Mr LOCK:⁵⁶ ... The Grains Board takes ownership of [the] grain as it is harvested and delivered into silos and pays growers normally within three to four weeks. However, the grain is sold over an extended period of time. Some pools take up to two years or more to close. To meet its payment obligations to growers, the Grains Board borrows from the Commonwealth Bank and the loan is progressively repaid as the board receives the proceeds of sale of the inventory.

The Commonwealth Bank and Rabo Bank lent the Grains Board a combined facility of \$200 million in 1998/99, and \$350 million in 1999/2000.

Best Practice – Dictionary of Investment Terms

The process of due diligence includes: “Ensuring that sufficient analysis has been conducted before making a loan or recommending an investment to a client.”⁵⁷

However, it appeared the Commonwealth Bank, at least, placed undue reliance on the fact the Grains Board was a statutory authority:

Mr LOCK:⁵⁸ We have provided such facilities to the Grains Board since 1995 and have relied upon its role as a statutory authority that the Minister appoints the members of the Board, that the Board is overseen by the Director-General and is audited by the Auditor-General.

The banks’ officers appeared to believe the Grains Board had a government guarantee:

CHAIR: But were you not concerned, given the volume traded had increased by 50 per cent over the last two years, given that the organisation still had the same capital base as it had in earlier years?

Mr LOCK:⁵⁹ I think we relied upon the fact that the Grains Board was a statutory authority and that meant a lot to us.

CHAIR: Because your money was secure?

Mr LOCK: Yes.

⁵⁶ General Manager, Corporate Banking Group, Commonwealth Bank of Australia, transcript of hearing, 30 November 2000 at p 55

⁵⁷ The Australian Financial Review, *Dictionary of Investment Terms* (1996) at p 73

⁵⁸ General Manager, Corporate Banking Group, Commonwealth Bank of Australia, transcript of hearing, 30 November 2000 at p 55

⁵⁹ Id at p 56



However, the statute clearly states the credit extended by the banks was not secure, nor guaranteed by the State Government. The banks wrongfully relied upon a state government guarantee that clearly did not exist.

The banks also relied on the audit reports:

CHAIR: Did you have confidence in the quality of the financial information that was being provided to you?

Mr LOCK:⁶⁰ We did, yes.

CHAIR: Because a lot of concerns were raised yesterday and today about the quality of the financial information. So you relied on the audited financial statements of the Grains Board and had confidence in those figures?

Mr LOCK: The audited accounts of the Grains Board were unqualified in every case. The monthly information that we got from the management was extracted from monthly board minutes, so it had been looked at by the board, and some of that information also formed part of the annual audit and part of the interim audit with the internal auditors.

However, from the Grains Board’s performance in 1999/2000, it appears the banks did not properly investigate its financial status before increasing the loans. As will be seen, the board was, more than likely, poorly informed by management. In addition, there were deficiencies in how the auditors reported their work. By relying on systems that had weaknesses, and not recognising those weaknesses, the banks made poor decisions. In other words, they did not exercise due diligence during their examinations. This was covered during hearings:

CHAIR: Just on the issue of the banks, do you believe that the banks were practicing proper due diligence in making these loans?

Mr HUBBARD:⁶¹ I am compelled to answer that, am I not? Clearly not.

The Grains Board, with the banks’ cooperation, increased its facility to \$350 million in 1999/2000. However, its capital base remained at a reported \$24.6 million on 31 August 1999. The Grains Board was, therefore, operating with a very high debt to equity ratio:

CHAIR: What would be the debt-to-equity ratio of the Grains Board at the peak period?

.....

Mr LOCK:⁶² ...if you took the audited numbers at the peak level of borrowing’s in this current season, it would be roughly in the order of 12 to 15 times.

⁶⁰ Id at p 58

⁶¹ Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 40



CHAIR: Twelve to 15 times. That is more than a bank, is it not?

Mr LOCK: Yes, it is.

In addition to this high gearing, the Grains Board's security for the loans were its holdings of grains, but their value depended on the world market and currency fluctuations. Both are highly volatile.

It is clear the Grains Board over-extended itself, and the banks cooperated. It is, likely therefore, the banks will absorb the bulk of the Grains Board's losses.

Internal Auditors

The Grains Board engaged PricewaterhouseCoopers to be the internal auditors. This function involves checking an organisation's internal controls and systems. Unlike external independent audit reports published in annual reports, internal audits are used by management and the board to gain assurance over, and improve, procedures. Internal audit reports are not automatically available to outsiders to assess an organisation's activities.

Audit Committees - Best Practice Guide

"An effective internal audit function should, among other things, evaluate and monitor the adequacy and effectiveness of the internal control structure."

"The audit committee can play an important role in ensuring that the internal audit function is effective by addressing such issues as the level of resources allocated to internal audit ... and the extent to which management reacts to the matters raised by internal audit."⁶³

The approach used by PricewaterhouseCoopers in conducting the internal audit was discussed in hearings:

CHAIR: Was that determined by the audit committee or did you have input into determining what area to audit?

Mr ELLIS:⁶⁴ The input we had was in consultation with the audit committee to ensure that over a three- or four-year period each sector of the business would have been covered at least once. It was ultimately signed off by the audit committee as the work they wanted us to undertake.

The contract between the Grains Board and PricewaterhouseCoopers set out the role of the internal auditors. It states:

⁶² General Manager, Corporate Banking Group, Commonwealth Bank of Australia, transcript of hearing, 30 November 2000 at p 57

⁶³ AARF, IIA, and AICD, *Audit Committees: Best Practice Guide* (1997) at p 25

⁶⁴ Internal Audit Partner, PricewaterhouseCoopers, Transcript of hearing, 30 November 2000 at p 1



Management is responsible for establishing and maintaining an effective internal control system as well as evaluating the effectiveness of the system. Final determination and assessment of audit risk and the scope of internal audit activity will remain the responsibility of the Audit Committee and Management...

If any illegal acts or material errors or irregularities come to our attention during the course of our internal audit projects, we will inform Management. It will be Management's responsibility to decide what further action to take, and to take such action.⁶⁵

The resources committed to internal audit was discussed in evidence:

CHAIR: ... Is \$26,000 enough money to be spent on an internal audit of an organisation like this one? How many employees would you have in there for how many days for \$26,000?

Mr WETMORE:⁶⁶ In total it was probably about 35 days worth of work.

CHAIR: So, 35 days worth of one person working?

Mr WETMORE: No, in this particular instance, I think we had three people in there, but the total days spent on the whole assignment would be approximately 35 days.

CHAIR: So you had three people in there for how many days?

Mr WETMORE: Probably two weeks at the most.

CHAIR: Three people for 10 days?

Mr WETMORE: Yes.

PricewaterhouseCoopers stated in evidence there were no indications during its work there were any fundamental problems with the Grains Board's procedures:

Mr GLACHAN: Did any member of the audit committee ever raise what you might consider to be unusual issues with you?

Mr ELLIS:⁶⁷ The audit committee never raised in my period of time any unusual matters at the audit committee meetings.

And:

Ms HODGKINSON: Did you in the course of your internal audit work uncover any concerns that would have led to significant financial losses for the Grains Board?

⁶⁵ Price Waterhouse Coopers, letter of engagement with the Grains Board, 16 March 2000 at p 2

⁶⁶ Internal Audit Partner, PricewaterhouseCoopers, Transcript of hearing, 30 November 2000 at p 7

⁶⁷ Id at p 1



Mr ELLIS:⁶⁸ In the period I was internal auditor we came across nothing that would lead us to ever believe the type of exposures now.

There were concerns during the hearings whether \$26,000 per annum was adequate for an internal audit. This equated to a team of three on site for 10 working days. PricewaterhouseCoopers initially argued the internal audit was adequate:

CHAIR: Did you ever feel that the internal audit areas were too narrow?

Mr ELLIS:⁶⁹ I would not say they were too narrow. As I say, the scope, though, was limited in every year, so you were not doing a lot of audit work in any one year. The areas themselves that were selected were not narrow but, as I say, the scope over the whole organisation was very limited in any one year.

CHAIR: You were not happy about that?

Mr ELLIS: I was comfortable, because that is the way the audit committee wanted to do the audit. That is how they approached us to do the internal audit.

CHAIR: How does it compare to other public companies?

Mr ELLIS: It varies. My experience has been that many companies do actually select areas of their internal audit work to be done. They do not do the whole organisation in any one year. Things are done in a cycle. It was customary to focus more on risk areas more often than possibly was done at the Grains Board. I did approach management in 1997 with a view that we should possibly sit back and reassess the risk areas of the business with a view to looking at the next audit plan, and ultimately management undertook that exercise in 1999 and it did form the basis for an internal audit plan, which was, to some degree, instigated at the conclusion of my appointment as internal auditor.

After sustained questioning, however, PricewaterhouseCoopers conceded the effort given to each part of the three-year cycle could have been increased:

CHAIR: That is not a lot of audit, is it, for an organisation as big as this? I understand that you were confined to a certain area and you only had to look at a certain area.

Mr WETMORE:⁷⁰ That was sufficient for those areas.

CHAIR: I understand that, but the issue is was there sufficient internal audit in your view for that organisation?

Mr WETMORE: Hindsight possibly says that they should have spent more effort in that area but hindsight also says they should have put more effort maybe into fixing some of the internal control problems.

⁶⁸ Internal Audit Partner, PricewaterhouseCoopers, Transcript of hearing, 30 November 2000 at p 5

⁶⁹ Id at p 2

⁷⁰ Internal audit partner, Price WaterhouseCoopers, transcript of hearing, 30 November 2000 at p 7



The Committee accepts a three-year rolling cycle for internal audit can be appropriate. However, there were a number of weaknesses in the internal audit program. For example, it appears the work done for each part of the cycle was probably insufficient. It also appears the work was largely driven by the internal auditors themselves, at least until 1998/99. If at any time PricewaterhouseCoopers believed the extent of the program was inadequate, they could have refused the contract. The Grains Board had a very high ratio of borrowing to equity, which indicated the need for greater assurance over controls.

However, despite these comments, primary responsibility for internal auditing rests with the audit committee, not with the internal auditors. The letter of engagement sets out the internal auditors' duties and clearly places the responsibility for implementation with the audit committee.

Evidence indicates the audit committee, under the post June 1999 board, improved:

CHAIR: You just accepted the charter that they gave you?

Mr WETMORE:⁷¹ In February I went through with Lance Blockley, the chairman of the audit committee, the risk profile and what we planned to do. He added something on joint ventures. He was pleased that we were going to cover forward exchange contracts and commodity hedging and he said that would be sufficient for this coming year.

The relationship between internal audit and the Audit Committee was also discussed in the earlier section: *Audit Committee*.

External Auditors – the Auditor-General and the NSW Audit Office

Best Practice – Professional Accounting Associations

“The primary responsibility of [external] auditors is reporting to shareholders.”⁷²

The responsibilities of external auditors to the board or audit committee include the reporting of significant deficiencies in the design or operation of internal controls, significant areas of disagreement with management, and repeated and unresolved findings.⁷³

An external auditor's role and responsibilities include “informing the board of any contentious issues, especially those that are unresolved.”⁷⁴

As the external auditor, the Audit Office provided the following reports annually:

⁷¹ Internal audit partner, PricewaterhouseCoopers, transcript of hearing, 30 November 2000 at p 7

⁷² Australian Society of CPAs and the Institute of Chartered Accountants, *Beyond the Gap* (1996) at p 11. See Chapter One for an analysis of who are the Grains Board's shareholders.

⁷³ See id at p 22

⁷⁴ Ibid



- an independent audit report on the financial statements, which was reproduced in the Grains Board's annual report;
- a report to Parliament, which also outlines the results of the annual audit. These reports were usually five pages, including two pages of financial tables;
- a statutory audit report to the Chairman of the board, the Minister and Treasurer, which provides a broad outline of the results of the annual audit. The reports were usually two pages; and
- a management letter to the Chairman of the board and the Managing Director. It included specific audit findings, implications, recommendations, and management responses.

Best Practice – Public Finance and Audit Act 1983

The Auditor-General is required to:

- provide an opinion on a true and fair view of the financial position and the transactions of statutory authorities (section 41C);
- “report to the statutory body, the Minister and the Treasurer as to the result of any such inspection and audit and as to such irregularities or other matters as in the judgement of the Auditor-General ... call for special notice” (section 43(2)); and
- report to the Legislative Assembly, in an annual report(s), on the examination of the Public Accounts and Total State Sector Accounts which comprise the general government sector agencies and public trading enterprises (section 52A).

The Auditor-General may also “generally report on any matter arising from audit which in the opinion of the Auditor-General should be brought to the attention of Parliament” (section 52(3)).

Committee Access to Audit Office Papers

During evidence, the Auditor-General advised he was unable to provide copies of the statutory audit reports and the management letters to the Committee. Mr Sendt stated in the Crown Solicitor's opinion this would be contrary to the secrecy provisions of the *Public Finance and Audit Act 1983* (section 38). Section 38 (2) specifically exempts the Auditor-General from the secrecy requirement of the Act in respect of a number of matters including:

- any matter necessary for the proper administration of the Act; or
- a report or communication authorised or required to be made by or under this Act.

The position of the Auditor-General in relation to disclosure of information to the Committee is unclear. Under section 57, the Committee's primary functions are:



- to examine the public accounts transmitted to the Legislative Assembly by the Treasurer;
- to examine the accounts of authorities audited by the Auditor-General; and
- to examine the opinions or reports of the Auditor-General.

The Committee maintains it is unable to properly fulfil its task of advising the Parliament without access to pertinent working documents of the Auditor-General, thus the Auditor-General is specifically exempted, by section 38(2), from the secrecy requirement of the Act. On the other hand, the Crown Solicitor's view is the Committee's functions do not extend to examining other documents such as the working papers of the Auditor-General prepared in the course of the audit.

With regards to the power to call for papers, the Crown Solicitor notes:

While the Act recognises that in the course of the exercise by the PAC of its function documents will be produced to it in evidence and provision is made for such evidence which relates to a secret or confidential matter to be taken in private and for the circumstances in which it can be published, there is no provision in the Act which expressly confers on the PAC the power to *require* a person to produce a document (emphasis added).⁷⁵

The Committee is concerned the Crown Solicitor's opinion sought by the Audit Office suggests the Committee does not have the power to call for documents, and throws doubt on the Committee's power to request working documents of the Auditor-General.

The provisions which enable the Committee to call for persons, papers etc, are section 58(11) of the *Public Finance and Audit Act 1983*:

The production of documents to the Committee shall be in accordance with the practice of the Legislative Assembly with respect to the production of documents to select committees of the Legislative Assembly.

and Standing Order 329 of the Legislative Assembly: "A Committee shall have power to send for persons, papers, records and exhibits." These provisions combined enable the Committee to call for persons, papers etc, as any other Committee of the House or Joint Committee.

The Committee obtained the statutory audit reports for the last four years from the Department of Agriculture. Further, the administrator of the Grains Board provided copies of the management letters. However, the Committee is of the view that for the purposes of its formal inquiries, it should not be precluded from direct access to the Auditor-General's documentation. This issue warrants further attention.

⁷⁵ Auditor-General's Report to Parliament for 2001, Volume One at p 213



Recommendation 3

The Committee is of the view that the matter of the Committee's powers should be clarified in the *Public Finance and Audit Act 1983* by expressly restating the Committee's existing powers, as has occurred with later Acts pertaining to parliamentary committees, such as section 31G of the *Ombudsman Act 1974*, section 69 of the *Independent Commission Against Corruption Act 1988*, and schedule 1(5) of the *Commission for Children and Young People Act 1998*.

In particular:

- the *Public Finance and Audit Act 1983* expressly reiterate "The Committee has power to send for persons, papers and records";
- the *Public Finance and Audit Act 1983* be amended to enable the Committee to call for papers and records; and
- the *Public Finance and Audit Act 1983* be amended to enable the Committee to access documentation from the Auditor-General. A provision similar to section 34(4) of the *Ombudsman Act 1974* would enable the Committee such access.

Independent Audit Report

These reports are required under section 41C of the *Public Finance and Audit Act 1983*. During evidence, many witnesses argued they did not see a need to actively monitor the Grains Board because the Audit Office had always given an unqualified audit report. However, unqualified independent audit reports have a strict meaning; namely, the financial statements do not contain a material mis-statement about the entity's position. This was explored in evidence:

Mr SENDT: ⁷⁶... The scope of our audit, as set out in the standard wording we use in every audit report, is to provide reasonable assurance whether the financial report is free of material misstatement. It is not a guarantee of 100 per cent accuracy... An unqualified audit opinion is also not a guarantee that the agency is properly managed in every respect. It is not a guarantee of the future success of a business nor a forecast of the future...

The Committee agrees with the Auditor-General. The audit report should be strictly interpreted and gives no guarantees about an organisation's future performance. From the rest of this chapter, it is clear many witnesses read too much into the audit report in order to excuse themselves from their own responsibilities to actively monitor or inform themselves about the Grains Board.

⁷⁶ Auditor-General of NSW, transcript of hearing, 30 November 2000 at p 61

**Best Practice – Auditing Standards**

“The auditor should obtain an understanding of internal auditing to make a preliminary assessment of its effect, if any, on control risk, and in determining external audit procedures.”

“In obtaining an understanding of internal auditing, the auditor would consider the scope and effectiveness of internal auditing’s operations, policies and procedures.”

“An effective internal auditing function will often allow a modification in the nature and timing, and a reduction in the extent of procedures performed by the external auditor, but cannot eliminate them entirely. In some cases, however, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures, for example when internal auditing is exclusively involved in performance audits.”⁷⁷

Another issue raised during hearings was the role of internal audit and whether failures in internal controls should affect the independent audit report. The Audit Office stated this was not so, provided there was some means available of verifying there was no material mis-statement in the financial statements:

Mr SENDT:⁷⁸ ... it is not our responsibility to check processes within an organisation. It is the responsibility of management to have proper processes in place, proper systems in place. It is the responsibility of the board of directors to ensure that management carries out that role. In conducting an audit, we may or may not rely on the processes and internal controls and systems that an agency has in place. As I said, if we do come across deficiencies in those systems, we have a responsibility to raise those with management.

The statutory audit reports confirm this approach. Each report from 1995/96 to 1998/99 states “Audit procedures were primarily aimed at achieving audit objectives and did not seek to confirm for management purposes the effectiveness of all internal controls.” In hearings, the Audit Office stated it used other processes than reliance on the internal controls in verifying the accounts:

CHAIR: In three years you have identified and pointed out to the board that stock reconciliations were not working but you never qualified on that basis, did you?

Mr KHEIR:⁷⁹ No, because we did not need to qualify because we were able to obtain other assurance, substantive assurance, that the figures in the accounts were materially correct...

This method was supported by Professor Allen Craswell, Faculty of Economics and Business, University of Sydney:

⁷⁷ Auditing Standard AUS 604, “Considering the Work of Internal Auditing” paras 9, 10 & 11

⁷⁸ Auditor-General of NSW, transcript of hearing, 30 November 2000 at p 62

⁷⁹ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 64



As stated in the evidence, in undertaking a financial statement audit, the auditor may rely upon the client's system of internal control. However, in the event that the system is flawed and cannot be relied upon, the auditor can undertake alternative procedures. It is unlikely that problems with the internal control system would warrant disclosure in the audit report. However, if other procedures cannot be undertaken, the auditor may be required to issue a qualified audit opinion based on a scope limitation. The evidence given by Mr Kheir suggests that the alternative procedures were used to overcome the inadequacies of the internal controls.⁸⁰

These pieces of evidence are consistent with the auditing standards which state an external auditor need not rely on internal controls. The fact the external auditors could not rely on internal controls is additional evidence the internal audit function was ineffective. Primary responsibility for this rests with the Audit Committee.

There is also the issue of to what extent the Audit Office sought to understand and assess the internal auditing, as required under the auditing standards. In evidence, the Audit Office approved of the internal audit program:

CHAIR: Were you happy with what [internal audit work] was planned?

Mr WHITE:⁸¹ We were seeing a rolling three-year plan and that was being considered by the audit committee, so to that degree it seemed an appropriate process. Equally, the firm delivering the internal audit services appeared to be appropriately skilled.

Given this approval, the Audit Office would be expected to make the most of internal audit. The best method would be to talk directly to the internal auditors (PricewaterhouseCoopers), however, communication was limited:

Mr TORBAY: What was your relationship with the Audit Office? Did they rely on your work, for example, and in which areas?

Mr WETMORE:⁸² I have not had any conversations with the Audit Office.

CHAIR: Mr Ellis?

Mr ELLIS:⁸³ During my time, other than the Audit Office being in attendance at the same audit committee meetings as myself, I had no other contacts with the Audit Office.

It is possible communication occurred at lower levels between the internal and external auditors, but this may not have been sufficient. The Audit Office should have made a greater attempt to understand the internal auditors' work, and on the evidence does not appear to have fully complied with the auditing standards. The

⁸⁰ Submission from Professor Craswell, 2 January 2001 at p 2

⁸¹ Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 78

⁸² Internal audit partner, PricewaterhouseCoopers, transcript of hearing, 30 November 2000 at p 4

⁸³ Internal audit partner, PricewaterhouseCoopers, transcript of hearing, 30 November 2000 at p 4



Committee cannot conclude this necessarily constituted a lack of due care by the Audit Office. However, without access to the working papers, the Committee cannot eliminate this possibility.

The departure from the standard did not necessarily increase the risk of an inaccurate audit report, given the Audit Office stated in evidence it used alternative procedures instead of relying on the internal controls.

On the evidence presented, the Committee considers the Audit Office met its responsibilities in preparing its independent audit reports.

Statutory Audit Report

The Audit Office usually forwarded this report to the Chairman of the Grains Board at the same time as the independent audit report. Copies were given to the Treasurer and the Minister for Agriculture. This report is required under section 43(2) of the *Public Finance and Audit Act 1983*.

Current Practice – Statutory Audit Reports

The intent of the statutory audit report is to convey three messages:

- the result of the audit (unqualified or otherwise);
- significant items detected in the course of the audit; and
- a detailed management letter in respect of the issues will be sent to management. The implication is Ministers can request copies of these letters from the agency concerned.

The reports were usually two pages long and gave only the broadest outline of the audit work. The report for 1995/96 stated there were no significant items, which the Committee has verified from the management letter. The reports for the next two years did raise significant items, but only listed them as short bullet points without any explanation of their significance. An example is the report for 1996/97. Table 2 below provides a full quote from the statutory report, and then an explanation derived from the more expansive management letter.

Table 2: Interpretation of the Grains Board’s 1996/97 Statutory Audit Report

Reference in Statutory Audit Report	Explanation (from Management Letter)
“Cut-off procedures for sales at year-end”	The board was required to approve an adjustment of \$2.993 million in the accounts for a number of invoices that had not been included.
“Need for formal regular reconciliations of inventory position and review by	It is difficult to confirm that all stock balances were correct. The difference between the book and audited balances was \$2.991 million. An amount of



appropriate officer”	\$621,936 remained unadjusted.
“Disclosure of rental income in respect of employee purchase of houses and FBT implications”	Two staff were leasing houses owned by the Grains Board, with options for later purchase. Their rent was deducted from their pay, instead of them paying it after receiving their income. This meant the Grains Board’s profits and its assets were understated. The staff could also reduce their fringe benefits tax.
“Control aspects of futures commodity trading/forward exchange contracts”	The Grains Board’s hedge policies required each hedge to be linked to a physical transaction. However, the policy was not complied with, allowing market speculation, which would breach the <i>Grains Marketing Act 1991</i> .

Source: Audit Office of NSW: statutory audit report and management letter for 1996/97

In the view of the Committee, these four items are clearly important and would be of obvious concern to the Minister for Agriculture, the Director-General of the Department of Agriculture, and the Treasurer. However, neither they nor their staff would be able to make this interpretation from the information provided in the statutory audit report. If the Auditor-General is required to report any irregularities that call for special notice, it would be reasonable to expect such reports would explain why the matter was so significant.

The current practice involves the statutory audit report implicitly inviting interest from the Minister and Treasurer to investigate management letters. However, this follow up does not always occur. The wording within the statutory audit reports did not activate the necessary inquiry that would have revealed the problems at the Grains Board.

In this instance the duties of the Auditor-General under section 43(2) do not appear to have been carried out properly. Although the Audit Office may argue the statutory audit reports had content that would invite further investigation, the Committee disagrees.

The statutory report for 1998/99 provided some explanation of the significant items. For example, in relation to a transfer of funds it stated:

An amount of \$2.7 million was approved by the board to be transferred from the growers’ residual interest in pools to the operating income of the Board. The amount would appear to represent the residual funds remaining after the finalisation of 1997/98 and prior year pools.⁸⁴

From this text, it appears the Grains Board adjusted its operating income in some way. Someone reading the letter could presume the matter needed investigation, but

⁸⁴ Audit Office, Statutory Audit Report, 16 December 1999 at p 1



would not be sure why. In actual fact, the Audit Office was very concerned about the transaction and said so to the board:

Mr WHITE:⁸⁵ This was with the board post-1 July 1999. We went to them and said, "this transaction does not have any supporting documentation. We cannot tell you whether it is valid. Are you aware of it?" and the board came back and said they approved it.

.....
Mr KHEIR:⁸⁶ They approved it after we said-

Mr WHITE: "What is this?"

Mr KHEIR: —"We are looking at the validity and the substance of this transaction or this transfer from the pool funds and management cannot explain it to us in terms that we can readily understand," but the board was quite happy to approve the transfer. At the end of the day, we got them to disclose it in the notes to the accounts of the Grains Board to say that that transfer had occurred, et cetera. We reported it in our statutory audit report and in a report to Parliament that it was a transfer for pool funds without any substance, in effect, that the board had approved. If it had not been approved by the board, I would have been mentioning it in my audit opinion.

The transaction appears more suspect when one notices the Grains Board made a profit of \$2.45 million in that period. It would have made a loss without the transfer. However, neither the Audit Office's concerns nor the importance of the transfer for the Grains Board's profit were adequately explained in the statutory report.

Report to Parliament

The Audit Office usually publish this report early in each calendar year. This report is required under section 52A of the *Public Finance and Audit Act 1983*. The reports are usually five pages, including two pages of financial tables. Similar to the statutory audit reports, they generally give only broad outlines of the audit work. For example, the only control issues for 1996/97 were as follows:

The cut-off procedures for sales at year-end need to be improved in order to account the sales correctly for the year.

Although bulk commodities can be difficult to control precisely, improved formal and regular reconciliations of inventory are recommended in order to better monitor and control the numerous stock movements that occur during the year.

⁸⁵ Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 77

⁸⁶ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 77



There were no lease agreements available for the lease with the State Rail Authority of the land occupied by the Board. The Board has buildings on those properties and they are currently being depreciated over five years.⁸⁷

This text, although containing more detail than the statutory audit report, again does not make clear why the items are significant. It does not explain their financial implications.

The reports to Parliament also give the Auditor-General scope to consider an entity's operations more widely, compared with the narrow focus of the statutory audit report. For example, the reports to Parliament mention the National Competition Policy review, the Grains Board's trading growth, the Audit Office review of its treasury operations, and its proposed grower equity scheme. They also mention the Grains Board's joint ventures, its associated company and the \$1.8 million in goodwill it capitalised after acquiring an associated entity.

However, the reports do not contain an explanation of these items. Although the Committee accepts it is not practice for this explanation to be contained in a report to Parliament, the report did not adequately explain or alert readers to the enhanced level of risks engaged by the Grains Board.

An example was the transfer that generated the Grains Board's profit for 1998/99. The Auditor-General's report for 2000, discussed it as follows:

During 1998/99 growers' residual interest in pools for the 1997/98 and prior years were finalised and an amount of \$2.7 million was transferred from growers' residual interest in pools to the income of the Board. The amount represented management's estimate of the final adjustment to pool management costs for those years. The Audit Office was not able to clearly determine the basis on which management arrived at this estimate.

This comment is an improvement on the statutory report, as the Audit Office had at least begun to explain its concerns about the transaction. However, the report to Parliament was the proper place to explain the financial implications of the transfer.

Although an accountant would be aware of concepts such as risk management and profit manipulation, the readers of the reports to Parliament are the general public and Members of Parliament. The majority of these people would need to have issues explained.

Recommendation 4

The Audit Office should take its wider audience into account in preparing the Auditor-General's reports to Parliament. These reports should explain why listed issues are significant and their financial implications.

⁸⁷ Auditor-General's Report to Parliament, 1998, vol 1 at p 288



Management Letters

These letters are generated in two phases. Firstly, a draft is provided to management for its response. The final letter is then sent to both the Chairman of the board and the Managing Director. Management letters contain audit observations, implications, recommendations, and responses from management. They can also provide the results of special reviews such as the Audit Office's late 1998 review of the Grains Board treasury and trading operations.

The use of management letters is based on convention and the auditing standards. They are not directly mentioned in legislation. For the four most recent letters, the number of issues raised by the Audit Office was between eight and seventeen. The letters were sent anytime between January and July the following year.

For the management letters for 1995/96 to 1997/98, Mr Fitzgerald was the Chief Financial Officer. For 1998/99, it was Mr Jacob. The management responses for the three earlier years are generally not cooperative. The four matters from the statutory audit report of 1996/97 can be used as examples. In relation to cut-off procedures at year-end, management responded as follows:

This is noted, procedure will be upgraded to ensure a tight cut-off period in future. It must be understood however that we rely on a number of "third parties" to provide information that forms part of the end of month and end of year information.⁸⁸

In relation to reconciliations of inventory:

Procedures are in place to ensure that all stock records are reconciled on a timely basis. This task is one that is being undertaken all year round and therefore sometimes (during the window that the audit is undertaken) seems to be unfinished.⁸⁹

For the rental of Grains Board houses by employees:

Both properties are certainly not being provided "rent free" as an examination of the contracts with Bizzell and the Wards will show. The treatment will not be changed as it is considered immaterial in the scope of our accounts.⁹⁰

In relation to futures commodity trading, the Grains Board's procedures manual included two important rules. Firstly, each individual hedge had to be linked to an anticipated future physical transaction. Secondly, the total level of hedging could not exceed the total value of physical transactions. The management letter expressed concern audit was not able to verify compliance with the first rule. Management's response only related to the second rule, ignoring the first:

⁸⁸ Audit Office, NSW Grains Board Management Letter, 1 June 1998, Appendix 17

⁸⁹ Id, Appendix 1

⁹⁰ Id, Appendix 4



A report is provided to the Board on a monthly basis that details all FX contracts currently being held by the NSW Grains Board. This report is provided with an estimate of all export sales and the value of FX contracts should not exceed the value of estimated export sales in accordance with the policy laid down in Part 11, section 11.3 of the procedures manual.⁹¹

Management's response for the letter of 1998/99, however, was very different. Out of 12 recommendations, management agreed with seven. One further recommendation had already been implemented. In addition, management listed for each item a person responsible for further action. If the matter was not addressed by the next audit, the Audit Office knew exactly whom to approach.

If each individual management letter were assessed in isolation, it would be regarded as a competent piece of work. However, some issues featured repeatedly. The issue of what action should have occurred in relation to repeat findings is considered next.

Treatment of Repeat Findings

A feature of the management letters, reports to Parliament, and the statutory audit reports is there was very limited reporting of repeat findings. For example, the following matters were contained in three reports to management:

- the recording and management of debtors (management letters for 95/96, 96/97, and 98/99);
- the reconciliation and accuracy of grain stock records (management letters for 96/97 to 98/99); and
- risk management of trading operations such as hedging of foreign currency transactions (management letters of 96/97 and 98/99, and special treasury review in late 1998).

The recurrence of the findings and the implications of the actions of management were not featured in the reports to Parliament. Nor was comment made of the generally hostile reaction by management to findings. This raises the issue of what action the Audit Office should have taken, given some of its important recommendations were not being implemented. The Committee has found a considerable body of evidence the Audit Office should have actively informed stakeholders of these matters.

Firstly, this issue arose in the case of *AWA v Daniels t/a Deloitte Haskins & Sells*.⁹² In that case, auditors found severe weaknesses in their client's forex internal controls. They informally told management of some of the defects, but preferred to wait until the formal closure of the audit to provide a full report. In the two and a half months between these two periods, management had not taken any action, but the auditors did not indicate any urgency when they discussed the issue at that

⁹¹ Id, Appendix 8

⁹² (1992) 10 Australian Company Law Cases (ACLCLC) 933



meeting. The auditors were found to be partially liable for the foreign exchange losses incurred by their client.

The Auditor-General's responsibilities are augmented by the *Public Finance and Audit Act 1983*. Section 52(3) allows the Auditor-General to report whatever in his or her opinion should be brought to the Parliament's attention. Section 43(2) states the statutory report should include any matters that call for "special notice." Although the Act does not provide specific guidance, repeated and unresolved findings should fit within this category.

The industry standard is also relevant. A best practice guide by the Australian Society of CPAs and the Institute of Chartered Accountants entitled *Beyond the Gap* clearly states an external auditor is responsible for informing the board of repeated and unresolved findings.

Professor Craswell of the University of Sydney commented Parliament should be advised of such issues:

Most of the problems relating to an auditor's failure to "follow up" have involved internal management practices but it is not clear to me what the appropriate action would be, in this case, if the managers did not follow the auditor's advice and improve the internal control system. Eventually, however, the auditor might be expected to report the problem to the owners or – in this case – to the Parliament.⁹³

The issue, therefore, is to what extent the Audit Office raised repeated and unresolved findings with the board and the Parliament. The Audit Office stated in evidence it provided informal briefings along these lines to the audit committee:

Mr TORBAY: Would you care to comment about the position of Mr Fitzgerald's or Mr Lawrence's openness to the suggestions that you were making or the corrective action recommendations that you were making? There has been some comment about it. I would be interested in your view.

Mr KHEIR:⁹⁴ It was always very defensive. Whenever we raised issues with Mr Fitzgerald, he was always very defensive about things, as he was today from our reading of it. He was always looking to rebut any suggestions for improvement that we were making. What made me concerned was that that attitude was not being particularly helpful towards improving the systems and processes. I actually made my views known to the old audit committee, the previous one. I expressed my concerns about the attitude and the fact that things were not being rectified as recommended. The committee took that on board. Not a great deal changed. The new board came on board in July 1999 and the first thing I did when I met with them was to say exactly those sentiments that I had about the willingness of Mr Fitzgerald to adopt recommended actions.

⁹³ Submission from Professor Craswell 2 January 2001 at p 3

⁹⁴ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 74



The Audit Office also stated it discussed repeat findings about stock reconciliations in its reports to Parliament. However, the only mention is in the 1998 report covering the 1996/97 year, before it became a repeat finding. The Audit Office also discussed its review of the Grains Board's treasury/trading operations in Volume One of the Report to Parliament for 1999. It stated:

The objectives of the review were to: consider the existing policy relating to trading in derivative transactions, examine the underlying considerations in relation to derivative transactions, review the extent of treasury operations and the relationship with the underlying business, and examine derivative transactions undertaken by the treasury function.

...the review did not reveal any instances where the Board had acted outside of its legislative capacity. A draft report outlining recommendations for improvement in procedures and documentation has been submitted to the Board for consideration and comment.⁹⁵

However, the report does not state the review was required because management refused to follow the Grains Board's own hedging procedures. Further issues with hedging arose in the 2000 report to Parliament, which again did not mention the issue was a repeat finding.

The Committee is prepared to accept the Audit Office made briefings to the audit committee about repeat and unresolved findings. However, it does not appear to have properly discussed these issues in its statutory audit reports or its reports to Parliament.

Recommendation 5

The Audit Office and Auditor-General should include significant repeat and unresolved findings in their statutory audit reports and reports to Parliament and label them accordingly.

Audit Risk Management

In 1998, the Audit Office selected a new financial audit methodology and supporting software system. Professor Craswell noted in his recent review of the Audit Office the system "represents the latest in private sector audit technology."⁹⁶

The new methodology focuses on understanding the client's business, the client's risks, and how they control those risks. Professor Craswell stated "audit staff can be expected to have a comparative advantage in the identification of risks."⁹⁷ The report then made a number of recommendations that sought to build on this new expertise to improve the Audit Office's services. They include:

⁹⁵ Auditor-General's Report to Parliament 1999, vol 1 at p 109

⁹⁶ Public Accounts Committee *Review of the Audit Office of NSW* (2000) Report No. 120 at p 15

⁹⁷ Id at p 24



- The Auditor-General's mandate should be extended to include the monitoring and expression of an opinion on the risk management disclosures included in the annual reports of government agencies (rec 16); and
- The Auditor-General should consider the benefits of integrating the staff in the Performance Audit Branch with the Financial Audit Branch to establish teams that are skills based and can more efficiently identify areas for improvement in public sector management (rec 20).

Risk was especially important for the Grains Board. As it pursued growth, the risk of bad results from its operations increased. This was especially so, given its capital base remained small compared with its sales and seasonal borrowing. One would expect the new methodology to have brought these increased risks to the attention of audit staff. However, when the Audit Office mentioned the Grains Board's growth in its reports to Parliament, the implications for risk were not raised:

CHAIR: ... Given that at the end 1998 it seemed that the volumes had increased quite substantially, probably 50 per cent, or around 50 per cent, it seems, in your management letter did you express a concern about the capitalisation of the Grains Board given that the volumes had increased so significantly?

Mr WHITE:⁹⁸ Not in the management letter. We reported to Parliament that there had been significant growth in the volumes of what had been traded. We did not draw the nexus between the capitalisation basis and the level of trading, but, generally, in highlighting the significant developments of that particular year we went through the growth in the trading.

CHAIR: But you did not relate it back to capitalisation?

Mr WHITE: I do not believe it was in that comment, no.

CHAIR: That is pretty important, is it not?

Mr KHEIR:⁹⁹ Well, it is, but—

CHAIR: A bank would not be doing that.

Mr KHEIR: Well, it depends on how well management and the board handles that sort of growth. As we were saying before, they had a plan in place to build on and actually increase the capacity of their systems to be able to handle that. As it turned out, that did not get far enough through the process to sort of see, perhaps, the light of day, but it is fairly hard for an external auditor signing off on a set of accounts as at 31 August 1999 to make a judgment about whether a board is going to be able to handle, with that capital base, the growth that it was experiencing. There was nothing to suggest, I suppose, to us at the time that decisions were being made which were going to lead to such a situation.

⁹⁸ Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 81

⁹⁹ Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November at p 81



The Committee accepts an Auditor-General's report to Parliament would not be able to predict whether the Grains Board would be able to handle future growth. However, it would be reasonable for the report to discuss growth as a possible area of risk (particularly in the context of such a thin capital base), and something the board of directors and management would need to monitor.

The issue of risk management disclosure in the annual reports of government agencies was clearly addressed by the Committee's review of the Audit Office in 1999/2000. As such, risk management disclosure had been identified by the Committee as an area needing improvement in the Audit Office processes.

Although such public commentary is not required of external audit in the private sector, it is recognised public sector auditors face additional demands. These include compliance with legislation and accountability.¹⁰⁰ This approach requires the Auditor-General to keep stakeholders informed of audit findings on business risks and potential risks.

Recommendation 6

The Auditor-General's statutory reports and reports to Parliament must explicitly report significant changes in a client's business risks from the previous year. The reports should include all critical findings about key business systems (not done in the case of the Grains Board).

Recommendations 16 and 20 from Professor Craswell's report are yet to be implemented. Recommendation 16 requires amending legislation, probably of either the *Public Finance and Audit Act 1983* or the annual reporting legislation. At present any risk management disclosure by agencies in annual reports is discretionary and there is no formal requirement for the Auditor-General to report on it.

It should be noted Treasury is managing a long-running review of the *Public Finance and Audit Act 1983*, which has not progressed for over ten years. There are options to take Professor Craswell's recommendation further:

Recommendation 7

The Auditor-General's current performance audit into risk management practices across government examine how the monitoring and expression of an opinion on the risk management disclosures included in annual reports of government departments and agencies might be implemented.

Recommendation 20 was rejected by the Audit Office.¹⁰¹ The previous review of the audit office in 1996 made a similar recommendation, which was also rejected.¹⁰²

¹⁰⁰ See Public Accounts Committee *Review of the Audit Office of NSW* (2000) Report No. 120 at pp 1&2

¹⁰¹ Id, see response by Auditor-General



The Committee, however, would like some attempt by the Audit Office to make the skills and expertise of the Performance Audit Branch available to the Financial Audit Branch.

Conclusions

Best Practice: The governance functions of an effective board include monitoring performance.

- Board members relied heavily on executive management, internal control systems, and the auditor's reports, without ensuring the Grains Board's procedures were being complied with.

Best Practice: It is the duty of the board to act honestly and with a reasonable degree of care and diligence in the exercise of their functions. Board members should inform themselves about the subject matter of any decisions to the extent they reasonably believe to be appropriate.

- Reporting was voluminous and the papers were sometimes distributed on the day of the meeting. Further, board members did not assert their right and obligation to be properly informed about the organisation's operations. This problem was not attempted to be rectified until the introduction of the new board in July 1999.

Best Practice: The governance functions of an effective board include setting strategic directions and risk management.

- Management were looking to grow. However, the vision had not been developed into an adequate strategy with the necessary direction and control to manage the increasing market and financial risks.

Best Practice: The Grain Marketing Act 1991 empowers the Grains Board's Consultative Committee to make recommendations with respect to the operations generally of the board.

- The Consultative Committee was not pro-active in reviewing the operations of the Grains Board. It relied on others for assurance on operational matters.

Best Practice: The audit committee has a responsibility to consider carefully issues raised by the external and internal auditors as those issues may have implications for the entity's control environment.

- The management of the Grains Board attended audit committee meetings and was allowed to "sweep aside" issues raised by the auditors.

¹⁰² Id, at p 5



Best Practice: The board/audit committee should create an atmosphere of openness and accessibility for audit feedback and discussion.

- The Chief Financial Officer was defensive and usually dismissed any recommendations from the auditors.

Best Practice: The function of an audit committee is to assist the board in overseeing responsibilities in relation to the appropriateness of the entity's financial reporting, internal control structure and processes, the quality of risk management systems, and the internal and external audit functions.

- The audit committee failed to deal with on-going audit findings, and auditors' recommendations were often not addressed. The audit committee failed to appropriately oversee the internal and external audit functions.

Best Practice: It is the responsibility of the audit committee to support internal audits by addressing the extent to which management reacts to the recommendations.

- The audit committee did not appear to take an active role in the audits, allowing the internal auditors to drive the procedure and allowing management to avoid implementing recommendations.

Best Practice: The Managing Director is responsible for the day to day running of an organisation.

- The former Managing Director, Mr Lawrence, denied responsibility by stating he relied on the work of others.

Best Practice: The Managing Director should ensure the management team is strong and competent, its members are capable of the tasks assigned to them and there is sufficient depth of support for management.

- The accounting and computer systems that supported the Grains Board were grossly inadequate, particularly in times during the expansion of the business. The Chief Financial Officer, Mr Fitzgerald, was responsible for these systems.

Best Practice: There should be no conflict between corporate and personal goals of the executive team.

- Mr Lawrence and Mr Fitzgerald had a long and close relationship. When the Board began to doubt Mr Fitzgerald's competence, his severance arrangements were generous and it was a long time before a replacement was obtained. Further, Mr Fitzgerald had received an interest free loan from the Grains Board without the board's knowledge or approval. This close relationship prevented Mr Lawrence from objectively executing his responsibilities as a Managing Director, resulting in sub-standard computer systems and accounts, contributing to its collapse.



Best Practice: The Grain Marketing Act 1991 requires the Director-General of the Department of Agriculture to review the activities of the Grains Board and to make regular reports on its activities. The Director-General must prepare and forward to the Minister a report in each twelve-month period. Further, the Director-General may require the conduct of management audits.

- No investigations were conducted by the Department of Agriculture into the Grains Board. Rather, the Director-General relied on the advice of others, such as the Auditor-General, to monitor the Grains Board's activities.

Best Practice: Treasury has a corporate objective to improve public sector accountability for State financial management.

- Treasury argued it did not actively monitor the Grains Board as the Government has no ownership interest, did not guarantee the Grains Board's operations and had no effect on the State's credit rating. However, Treasury has contradicted itself by supporting lending of up to \$13 million to the Grains Board creating a financial exposure for the Crown.

Best Practice: The process of due diligence includes ensuring sufficient analysis has been conducted before making a loan or recommending an investment to a client.

- The Commonwealth Bank placed undue reliance on the fact the Grains Board was a statutory authority. The banks' officers appeared to believe the Grains Board had a government guarantee. However, the Act clearly states the credit extended by the banks was not secure, nor guaranteed by the State Government. The banks also relied on the audit reports. It appears the banks did not properly investigate the Grains Board's financial status before increasing the loans.

Best Practice: Internal audit functions should, amongst other things, evaluate and monitor the adequacy and effectiveness of the internal control structure.

- The internal auditors conceded, in hindsight, the Grains Board should have put more effort into internal audit and addressing internal control problems.

Best Practice: The audit committee can play an important role in ensuring the internal audit function is effective by addressing such issues as the level of resources allocated to internal audit, and the extent to which management reacts to the matters raised by internal audit.

- There was evidence indicating that the work was largely driven by the internal auditors themselves. This is despite primary responsibility for internal auditing resting with the audit committee.



Best Practice: The external auditor should obtain an understanding of internal auditing to make a preliminary assessment of its effect, if any, on control risk, and in determining external audit procedures.

- There should have been more communication at the senior level between the internal and external auditors, which would have allowed the Audit Office to better understand the internal auditors' work. The Audit Office may not have complied with the auditing standard in this regard.

Best Practice: One of the aims of the statutory audit reports is to inform Ministers that a detailed management letter will be forwarded to the agency. The implication is Ministers can request copies of these letters from the agency concerned.

- This follow up does not always occur across Government. In the case of the Grains Board, the content of the statutory audit reports was not sufficient to activate the necessary inquiry that would have revealed the problems within the organisation.

Best Practice: An external auditor is responsible for informing the stakeholders of repeated and unresolved findings.

- The Audit Office did not label long standing problems as repeat and unresolved findings in its statutory audit reports or management letters. The Audit Office's reports to Parliament provided another avenue to disclose this information, but this opportunity was not taken.